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Supreme Court, U.S.
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No. 85-

IN THE

Supreme Court of the United States

OCTOBER TERM, 1985

PAPAGO TRIBAL UTILITY AUTHORITY,

Petitioner,

v.

FEDERAL ENERGY REGULATORY COMMISSION,

Respondent.

On Petition For A Writ Of Certiorari To The United States Court of Appeals For The Ninth Circuit With A Suggestion Of Summary Disposition

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APPENDIX

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January 8, 1986

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APPENDIX A

Order of the United States Court of Appeals for the Ninth Circuit (Reported at 773 F.2d 1056)

PAPAGO TRIBAL UTILITY AUTHORITY, *Petitioner*,

v.

FEDERAL ENERGY REGULATORY COMMISSION, *Respondent*.

ARIZONA PUBLIC SERVICE COMPANY, *Intervenors*.

ARIZONA PUBLIC SERVICE COMPANY, *Petitioner*,

v.

FEDERAL ENERGY REGULATORY COMMISSION, *Respondent*,

ARIZONA POWER AUTHORITY, *et al.*, *Intervenors*.

ARIZONA POWER AUTHORITY, ELECTRICAL DISTRICT NO. ONE, ELECTRICAL DISTRICT NO. 3, ELECTRICAL DISTRICT NO. 6, ELECTRICAL DISTRICT NO. 7, Roosevelt Irrigation District, Buckeye Water Conservation District, Maricopa County Municipal Water Conservation District No. 1, *Petitioners*,

v.

FEDERAL ENERGY REGULATORY COMMISSION, *Respondent*.

Nos. 84-7012, 84-7119, 84-7155, 84-7278 and 84-7310.

United States Court of Appeals, Ninth Circuit.
Argued and Submitted Dec. 14, 1984.

Decided Oct. 10, 1985.

On Petition for Review of Orders of the Federal Energy Regulatory Commission.

Before WRIGHT and POOLE, Circuit Judges, and TAKASUGI, District Judge.*

POOLE, Circuit Judge:

The Arizona Public Service Company (APS), a utility company that supplies power to most of Arizona, and several of its wholesale customers, appeal from two rate-making decisions of the Federal Energy Regulatory Commission (FERC). APS had proposed a rate increase that the wholesale customers opposed. APS and the wholesale customers now challenge various aspects of the FERC's resolution of the rate-making dispute.

FACTS

A. The Parties

APS is an investor-owned public utility that sells wholesale and retail electricity to customers throughout Arizona. Its wholesale sales are regulated by the FERC under the Federal Power Act, 16 U.S.C. §§ 824 *et seq.* The remaining petitioners are all wholesale purchasers of electricity from APS. Papago Tribal Utility Authority (Papago) provides electrical service for the Papago Indian reservation located near Tucson, Arizona. Arizona Power Authority (APA) is a state agency that provides electricity to municipalities and other jurisdictions within Arizona. The districts primarily provide electricity for pumping water used in irrigation.

B. The Proceedings

On December 18, 1980, APS filed proposed wholesale rate increases with the FERC. The proposed increases amounted to $14.7 million, or 25.5 percent. Papago, APA, and the districts challenged the proposed rate increases and moved to intervene in the matter.

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* The Honorable Robert M. Takasugi, United States District Judge for the Central District of California, sitting by designation.

On February 27, 1981, the FERC issued an order allowing the rate increases to take effect as of March 2, 1981, subject to APS' promise to refund any amounts collected under rates that proved to be excessive. The FERC granted motions of Papago, APA, and the districts to intervene, and set the matter for a hearing before an administrative law judge (ALJ).

The hearing ("phase I") was convened on November 17, 1981, and concluded a month later. Among the issues included were whether the FERC's "test year" procedures should be modified to reflect certain planned sales of power by APS, whether the savings from certain of APS' investment tax credits should be passed on to ratepayers, and whether ratepayers should be required to pay for the construction of Palo Verde nuclear power plant.

On March 8, 1982, before the ALJ had disposed of the case, the FERC's Staff Counsel moved to reopen the matter for the purpose of exploring ratemaking issues arising out of a sale of tax benefits by APS. The transaction was structured so that APS sold its newly completed Cholla 4 steam electric generating station to General Electric Company (General Electric) for a $50.6 million cash downpayment and a note that provided for installment payments by General Electric. General Electric immediately leased Cholla 4 back to APS, the lease payments equaling the installment payments. The net results was that General Electric paid $50.6 million for the tax benefits of owning Cholla 4, pursuant to the Economic Recovery Tax Act of 1981 (ERTA), while APS retained use and control of the facility. The ALJ ordered that a second hearing be held ("phase II") to consider the Cholla 4 transaction. The phase II hearing was held on May 17-21, 1982.

On October 15, 1982, the ALJ issued the decision in phase I. On February 25, 1983, the ALJ issued the decision in phase II. The FERC affirmed both decisions, and the parties timely appealed to this court, where their appeals were consolidated.

DISCUSSION

I. STANDARD OF REVIEW

In a complex ratemaking case such as the present one, we defer to the FERC's substantial expertise. *See Gainesville Utilities Dep't. v. Florida Power Corp.*, 402 U.S. 515, 528, 91 S.Ct. 1592, 1599, 29 L.Ed.2d 74 (1971). The findings of the Commission as to the facts, if supported by substantial evidence, shall be conclusive. 16 U.S.C. § 825l (1982); *Cities of Riverside and Colton v. FERC*, 765 F.2d 1434, 1438 (9th Cir.1985). Moreover, "the breadth and complexity of the Commission's responsibilities demand that it be given every reasonable opportunity to formulate methods of regulation appropriate for the solution of its intensely practical difficulties. * * * [T]herefore * * * the Commission's orders may not be overturned if they produce 'no arbitrary result.' " *Nevada Power Co. v. FPC*, 589 F.2d 1002, 1005-06 (9th Cir.1979) (quoting *Permian Basin Area Rate Cases*, 390 U.S. 747, 790-92, 88 S.Ct. 1344, 1372-73, 20 L.Ed.2d 312 (1968)); *see Cities of Riverside and Colton*, 765 F.2d at 1438. "If the total effect of the rate order cannot be said to be unjust and unreasonable, judicial inquiry under the Act is at an end. * * * [T]he Commission's order * * * is the product of expert judgment which carries a presumption of validity." *Nevada Power*, 589 F.2d at 1006 (quoting *FPC v. Hope Natural Gas Co.*, 320 U.S. 591, 602, 64 S.Ct. 281, 287, 88 L.Ed. 333 (1944)). In reviewing a Commission order, the court has three responsibilities.

> First, it must determine whether the Commission's order, viewed in light of the relevant facts and of the Commission's broad regulatory duties, abused or exceeded its authority. Second, the court must examine the manner in which the Commission has employed the methods of regulation which it has itself selected, and must decide whether each of the order's essential elements is supported by substantial evidence. Third, the court must determine whether the order may reasonably be expected to maintain financial integrity, attract necessary capital, and fairly compensate investors for the risks they have assumed, and yet provide

> appropriate protection to the relevant public interests * * * * The court's responsibility is not to supplant the Commission's balance of these interests with one more nearly to its liking, but instead to assure itself that the Commission has given reasoned consideration to each of the pertinent factors.

Permian Basin Area Rate Cases, 390 U.S. 747, 791-92, 88 S.Ct. 1344, 1372-73, 20 L.Ed.2d 312 (1968).

II. PHASE I OF THE PROCEEDINGS

A. Application of the Test Year Procedure.

When a regulated utility proposes a wholesale rate increase, the FERC requires the utility to submit cost of service data for two time periods. Period I contains actual data for the most recent twelve months. Period II, the test year, contains estimated cost of service data for any twelve consecutive months beginning after the end of Period I but no later than the proposed effective date of the rate filing. 18 C.F.R. § 35.13 (1984); *Indiana Municipal Electric Association v. FERC*, 629 F.2d 480, 481 (7th Cir.1980). The FERC adopted the test year approach because the historic test period exclusively used in the past was too rigid to result in just and reasonable rates. *Id.* If, as is often the case, the actual data for the test year becomes available during the course of ratemaking proceedings, the FERC need not adjust the test year estimates. *Boroughs of Ellwood City v. FERC*, 731 F.2D 959, 966 (D.C.Cir.1984). Rather, the FERC determines whether the test year estimates were reasonable when they were made. If so, the FERC will follow the estimates unless they are substantially in error and would yield unreasonable results. *Id.; Indiana Municipal Electric Association*, 629 F.2d at 483-85.

In December, 1980, when APS filed its proposed rate increases with the FERC, it submitted projected financial data for 1981 as its test year estimates. Those test year estimates did not include revenues that APS was planning to receive in the future from post-test year layoff sales of power to third parties. Papago challenges the FERC's re-

fusal to provide a automatic rate adjustment of APS' rates for revenues received from layoff sales which occur after the test year. Papago contends that APS will be paid twice for the same capacity if no such provision is made because the test year estimates included the costs associated with the capacity that will be sold to third party purchasers in the future.

The ALJ found that the post-test year layoff sales should not be considered part of this case, and ruled that the issue was moot. Rather, the ALJ found that the issue should be reserved for separate proceedings arising out of a rate increase filed by APS on April 29, 1982. In affirming the ALJ's decision, the Commission held that whether or not the issue was moot, the facts were not egregious enough to warrant a departure from its "longstanding policy" of determining rates based on test year estimates. Indeed, the Commission stated that it might not be fair to require a credit for post-test year layoff sales without considering possible post-test year cost increases.

As the Commission recognized, Papago's concern that APS would be paid twice for the same capacity has some merit. This does not mean, however, that the Commission should have adjusted the test year estimates. The Commission concedes and reviewing courts admit that the test year approach presupposes certain inexactness. *See, e.g., Cities of Batavia, etc. v. FERC*, 672 F.2D 64, 74 (D.C.Cir.1982). "The Commission rightly does not require that history prove the accuracy of the utilities' estimates * * * ." *Indiana & Michigan Municipal District v. FERC*, 659 F.2d 1193, 1198 (D.C.Cir.1981). It "is justified in setting a rather high threshold for parties seeking to adjust test year data * * *." *Boroughs of Ellwood City*, 731 F.2d at 967. It did not abuse its discretion in this case in refusing to adjust the test year estimates. The estimates were reasonable when made because APS did not plan to receive, nor did it receive, revenues from these sales during the test year. The fact that APS will receive these revenues in the future is not sufficient to establish that the estimates were "substantially in error" and would

"yield unreasonable results." *See id.* at 966. Therefore the Commission's refusal to adjust the test year estimates for post test year layoff sales is affirmed.

B. APS' Investment in Palo Verde

Papago contends that the FERC erred in approving a rate increase that was based in part on the cost of financing construction of the Palo Verde nuclear power plant. It argues that APS' investment in the plant is unnecessary because Palo Verde will not be "used and useful" in providing service and because energy conservation is a much less expensive alternative to building the plant. Because Papago's arguments in this regard are almost entirely factual, we consider only whether the FERC's findings are supported by substantial evidence. *See* 16 U.S.C. § 825*l* (1982); *Cities of Riverside and Colton v. FERC*, 765 F.2d at 1438.

The ALJ rejected APS' initial contention that the decision to construct Palo Verde was beyond FERC review. The ALJ found that even though the plant was not in service and hence was not included in the rate base during the test year, its construction would affect current ratepayers because the utility sells securities to finance the construction, and the FERC considers APS' need for capital in establishing its rate of return allowance. The ALJ then thoroughly analyzed Papago's arguments and evidence relating to Palo Verde, and the arguments and evidence offered by APS in rebuttal. The ALJ's rejection of Papago's position was affirmed without comment by the FERC.

The test for determining whether an investment may be included in a utility's rate base is whether it is "used and useful" in providing service to current customers. *Anaheim, Riverside, Banning, Colton, and Azusa, California v. FERC*, 669 F.2d 799, 808 (D.C.Cir.1981). The ALJ summarized Papago's evidence that rates would be lower without Palo Verde construction costs, and that there was untapped potential for energy conservation in APS' service area. Based on the record, however, the ALJ concluded that the Palo Verde plant will be used and useful to meet APS' service requirements. The ALJ found that the evidence

> stopped considerably short of a convincing showing that the capacity and energy of the Palo Verde plant would not be required to meet the demands in APS' service territory. By no stretch of the imagination did PTUA make out a case showing that the utility's participation in the construction of the Palo Verde plant was the result of imprudent judgment on the part of its management.

Finding no evidence that the financing of the Palo Verde plant was erroneous, the ALJ rejected Papago's claim that the return allowance should be reduced to eliminate the effects of APS' requirements for capital to support the plant. Although Papago urges us to reconsider the ALJ's conclusion, substantial evidence in the record supports it.

The ALJ also carefully analyzed the contention that APS' rate increase be reduced or denied because APS has not adequately investigated conservation measures as an alternative to new plant construction. He concluded that Papago failed to prove that APS had acted imprudently in failing to implement a program of conservation incentives that, prior to the hearing, "lay dormant in the breast of [Papago's witness]." The ALJ found that APS' actions were not imprudent because they were consistent with the performance of other similarly situated utilities. In addition, the ALJ found that APS had implemented "a large number of innovative and constructive steps to spur conservation of electric energy in its service area." Because ample evidence in the record supports the ALJ's findings, we will not disturb them on appeal.

C. Normalization of Investment Tax Credits.

After APS filed the Notice of Rate Change in December of 1980 (Docket ER 81-179) that initiated this case, Congress passed the Economic Recovery Tax Act which requires, among other things, that public utilities use the normalization method of accounting for investment tax credits (ITCs). *See* S.Rep. No. 144, 97th Cong., 1st Sess. 57, *reprinted in* 1981 U.S. Code Cong. & Ad.News 161-

62. ERTA contained a transitional rule applicable to utilities which had previously flowed through ITCs. Those utilities would not lose the right to use ITCs on their tax returns if they secured the right to normalize in the first rate order issued with respect to it after the date of enactment of ERTA (August 13, 1981) and such rate order is issued before January 1, 1983. Economic Recovery Tax Act of 1981, Pub.L. No. 97-34, 95 Stat. 226-227, *reprinted in* Internal Revenue Acts, 1980-81, at 346-47.

The issue here is when the normalization method should be adopted. In its December 30, 1982 order the Commission initially considered this issue, and rejected APS' position that ERTA requires that normalization be adopted in this proceeding. Use of the normalization method in APS' April, 1982 rate filing (Docket ER 82-481) satisfied ERTA's requirements. The Commission decided this issue without prejudice to final determination of this matter in its Phase I opinion. "Order Determining Cost of Service For Purpose of ERTA Compliance," 21 FERC ¶ 61,384 (1982).

The ALJ considered the issue in Phase I of the proceedings. He agreed with the Commission's preliminary conclusion that ERTA does not require the use of the normalization method in this proceeding.

The Commission, in Opinion No. 177, 23 FERC ¶ 61,419 (1983), reversed the ALJ on this point. It concluded that normalization "is consistent with Commission policy on this issue, it conforms to Commission Order Nos. 144 and 144-A, and it will not result in rates higher than the overall rate level sought by APS in this proceeding."

Papago appeals that decision. It argues, first, that ERTA does not require utilities to normalize ITC immediately. The Commission's decision to normalize ITCs in this proceeding is within its discretion, however, and is consistent with both Congress's goals and Commission policy. *See* "General Explanation of the Economic Recovery Tax Act of 1981," Staff of the Joint Committee on Taxation, at 101, (December 29, 1981), *reprinted in* Internal Revenue

Acts, 1980-81, at 1475-76; "Policy Statement Regarding Income Tax Normalization Under the Economic Recovery Tax Act of 1981," 20 FERC ¶ 61,451 (1982).

Papago next argues that the Commission's order contradicts its earlier December 30, 1982 order on the same issue. This argument fails, however, because that order was made without prejudice to its formal determination in this proceeding.

Papago also claims that the ERTA normalization requirement is irrelevant here because APS sold all of its ITCs to General Electric in the Cholla No. 4 safe-harbor transaction. The record shows, however, that APS has post-1980 recovery property other than the Cholla No. 4 generating unit that was the subject of the safe-harbor transaction. Thus, Papago's fails on this issue as well.

Finally, Papago argues that ITCs are tax saving, rather than tax deferral, items and thus are not properly subject to the normalization provision of ERTA. This argument is technically correct: the Commission in fact permitted "'ratable flow-through" of ITCs, rather than normalization.[1] Normalization is used as a synonym, however, and is clearly required by the Congress in ERTA. *See* ERTA, Pub.L. No. 97-34, 95 Stat. 226-227, *reprinted in* Internal Revenue Acts, 1980-81, at 346-47.

III. PHASE II OF THE PROCEEDINGS; PROPER TREATMENT OF THE $50.6 MILLION PROCEEDS OF THE CHOLLA NO. 4 SAFE HARBOR TRANSACTION.

As indicated above, in 1981, APS entered into a "safe harbor" leasing agreement with General Electric, under which APS transferred to General Electric the right to

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[1]To normalize or ratably flow-through ITCs is to evenly spread the credit to the utility's present and future ratepayers over the useful life of the property giving rise to the credit. To flow-through the ITCs is to give an immediate benefit of the total ITC to the current ratepayers. *Arizona Public Service Co.*, Docket No. ER-82-481-000, 25 FERC ¶ 63,025 at 65,061 (1983), *aff'd*, 27 FERC ¶ 61,185 (1984).

take depreciation deductions under the Accelerated Cost Recovery System (ACRS) and to use investment tax credits (ITCs) stemming from APS' investment in Cholla No. 4. Under the terms of the agreement, General Electric paid APS $50.6 million in cash at the time the contract was executed and promised to pay the balance of the "purchase price" of $250 million (an amount equal to APS' adjusted basis of the Cholla No. 4 unit for tax purposes) in installments over the 42-year life of the lease. The periodic payments were exactly offset by the amount of the rental payments that APS was obligated to make for the lease-back of the unit. APS' rent payments are fully tax deductible, and only the interest portion of the installment payments from General Electric is includable in income. At the end of the 42-year term of the lease, ownership of the unit vests in APS.

Under the "safe harbor" leasing provision of section 201(a) of ERTA, I.R.C. § 168(f)(8),

> a transaction will be characterized as a lease for the purpose of allowing investment credits and capital cost recovery allowances to the nominal lessor. Lessors will be able to receive cost recovery allowances and investment tax credits with respect to qualified leased property, while it is expected that lessees will receive a very significant portion of the benefit of these tax advantages through reduced rental charges for the property (in the case of finance leases) or cash payments and/or reduced rental charges in the case of sale-leaseback transactions.

S.Rep. No. 144, 97th Cong., 1st Sess. 62 (1981), *reprinted in* 1981 U.S.Code Cong. & Ad.News 167. Thus, ERTA provided that APS' transaction with General Electric be characterized as a lease. The issue here is how to treat this transaction for ratemaking purposes.

Under public utility cost of service ratemaking principles, taxes are one element of the company's cost of service. *Public Systems v. FERC*, 709 F.2d 73, 75 (D.C.Cir.1983). Because ratepayers are being charged for

the utility's tax costs, the ratepayers receive the tax benefits associated with those expenses. *Id.* at 76. Thus, the tax benefits which APS sold would have inured to the benefit of APS' ratepayers. Because the ratepayers would have received these tax benefits over time, there is significant dispute among the parties about the present value of this loss. In addition, the company asserted that any loss was offset by gains attributable to the transaction.

The ALJ found that the net present value of the tax benefits transferred by APS, in terms of the increase in its cost-of-service tax expense, was $47 million, and that the amount the ratepayers lost in reduced rates was $123.5 million. In determining how to compensate the ratepayers for their loss, the ALJ carefully considered the proposals of the parties. He rejected the parties' proposals to apportion the proceeds between an amount paid for the ACRS deductions and a separate amount paid for the ITCs because the proposals were grounded on the legal fiction that a separate sum was paid for each. Rather he concluded that the $50.6 million APS received from General Electric constituted a negotiated price for a package of nonseverable tax benefits. Because the ALJ found that the transaction was not an imprudent one for APS to enter into, he refused to punish the utility by requiring it to reduce its cost of service by some larger amount than it actually realized from the sale in an attempt to make whole the ratepayers.

The ALJ considered and rejected simply disregarding the tax benefit transfer transaction and prescribing APS' rates as if it had never occurred, preferring instead to recognize the realities of the transaction and not to adopt the fictitious premises that the tax benefits remain in APS' hands. He decided, therefore, that the entire amount of the proceeds ($50.6 million) should be amortized as a credit to the cost of service over the economic life of Cholla No. 4, and that the unamortized balance of the proceeds should be deducted from the utility's rate base.

In Opinion No. 193, 25 FERC ¶ 61,092 (1983), the Commission affirmed the ALJ's decision with one exception.

The ALJ had ordered that the proceeds be amortized over the entire twelve months of the test year. The Commission ordered that the amortization of the $50.6 million by synchronized with the Cholla No. 4 in-service date so that the proceeds would be amortized as of June, 1981, when Cholla No. 4 was placed in service. The Commission's order on rehearing, Opinion No. 193-A, 25 FERC ¶ 61,393 (1983), rejected APS' argument that the ALJ's treatment of the $50.6 million violated ERTA and again affirmed the ALJ's decision.

APS now challenges the ALJ's decision on several grounds. First, it argues that the Commission erred in adjusting its test year estimates to take the Cholla 4 transaction into account. Because the test year estimates were prepared prior to the enactment of ERTA, all of the parties agree that the test year estimates were reasonable when made. *See Villages of Chatham, etc. v. FERC*, 662 F.2d 23, 34 (D.C.Cir.1981). ERTA was enacted and the tax benefits were sold during the test year. The issue is whether "subsequent events indicate that to use [the estimate] as a basis for future projections would yield unreasonable results." *Indiana & Michigan Municipal Distributors v. FERC*, 659 F.2d 1193, 1198 (D.C.Cir.1981) (quoting *Indiana Municipal Electric Association v. FERC*, 629 F.2d 480, 485 (7th Cir.1980)). The ALJ found that because the Cholla 4 transaction took place pursuant to an unforeseen change in the tax laws, it warranted an adjustment to the test year estimates. The FERC affirmed.

APS contends that the decisions of the ALJ and FERC indicate that the FERC did not find the effect of the Cholla 4 transaction to be substantial, and thus the FERC erred in adjusting the test year estimates. The FERC's decision, however, expressly stated that the FERC "has made exceptions to its traditional adherence to the test-year concept in cases where there are known and measureable changes of a substantial nature. That is the case here." Opinion No. 193, 25 FERC ¶ 61,092 at 61,308 (footnote omitted). The FERC also expressly rejected APS' contention that the $50.6 million Cholla 4 transaction had

a *de minimis* effect on revenue. *Id.* In light of the latitude courts have given the Commission to determine whether to adopt or reject actual data from the test year, *see Indiana & Michigan Municipal Distributors,* 659 F.2d at 1197-98; *Indiana Municipal Electric Association,* 629 F.2d at 481, we find that the FERC did not abuse its discretion in adjusting the test year estimates based on an unforeseen transaction of such magnitude. *See Distrigas of Mass. Corp. v. FERC,* 737 F.2d, 1208, 1220 (1st Cir.1984) (FERC not required to use test year figures when later information reveals estimates based on those figures likely to be seriously in error).

APS next argues that the ALJ's computation of the loss incurred by the ratepayers as a result of the safe harbor transaction was erroneous. APS argues that the ALJ's findings are not supported by substantial evidence and must be reversed. APS' argument ignores the Commission's conclusion that it need not rely upon the ALJ's calculation of the precise amount of extra costs the ratepayers will incur because it adjusted the cost-of-service only by the amount of the proceeds. Opinion No. 193, 25 FERC ¶ 61,092 at 61,309. Thus, the evidence need only support the Commission's position that the ratepayers' loss amounted to at least $50.6 million. APS cannot dispute that figure because it has conceded that the net present value of costs the ratepayers will incur is $82.6 million.

Third, APS argues that the ALJ's treatment of the proceeds from the safe-harbor transaction violates I.R.C. § 168(f)(8) as amended by the Technical Corrections Act of 1982. The Act amended § 168(f)(8)(D) as follows: "[u]nder regulations prescribed by the [Treasury] Secretary, public utility property shall not be treated as qualified leased property unless the requirements of rules similar to the rules of subsection (e)(3) of this section and section 46(f) are met with respect to such property." Pub.L. No. 97-448, 96 Stat. 2365, 2369 (1982), *reprinted in* Internal Revenue Acts, 1982, at 350.

Sections 168(e)(3) and 46(f) require utilities to use the normalization method of accounting[2] for ACRS depreciation deductions and ITCs, respectively. Thus, APS argues that the proceeds of the safe-harbor transaction must be apportioned between those attributable to ITCs and ACRS and that each portion of the proceeds must be treated differently from the method chosen by the ALJ. The Commission in its order on rehearing, Opinion No. 193-A, 25 FERC ¶ 61,393 (1983), addressed this contention. It rejected APS' interpretation of the amendment and found the amendment's meaning ambiguous. *Id.* at 61,871. The Commission interpreted the amendment as applying to the ACRS deductions and ITCs themselves and not to the proceeds of the sale of the tax benefits. It stated, however, that if the Treasury Department issued regulations pursuant to this amendment which indicate that its treatment is contrary to the tax laws it will reconsider its decision. *Id.*

We agree with the Commission that the amendment's meaning is unclear; we have found no subsequent authority clarifying its meaning. This is not surprising because the safe harbor leasing provision was short-lived: it was repealed the year after it was enacted. Section 209 of the Tax Equity and Fiscal Responsibility Act of 1982, Pub.L.

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[2]Normalization of accelerated depreciation methods means that the rates charged to utility customers do not reflect a ratemaking allowance for Federal income taxes based on the use of a depreciation method more accelerated than the depreciation method used to determine the ratemaking allowance for depreciation. It results in an actual Federal income tax expense that was less than the ratemaking tax allowance in the early years of an asset's useful life and more than the ratemaking allowance in the later years of an asset's useful life. These "deferred taxes" could be viewed as an interest-free loan to the utility. General Explanation of the Economic Recovery Tax Act of 1981, prepared by the Joint Committee on Taxation, *reprinted in* Internal Revenue Acts, 1980-1981, at 1445.

The use of accelerated depreciation in ratemaking to compute the allowance for federal income taxes is known as "flow-through" accounting, because current tax reductions are immediately reflected in lower rates to customers. *Id.* at 1446.

No. 97-248, 96 Stat. 324, 442, *reprinted in* Internal Revenue Acts, 1982, at 41. Because the Commission's decision is supported by clearly articulated reasons, we cannot say that it abused its discretion in rejecting APS' contentions. *See Ohio Power Co. v. FERC*, 668 F.2d 880, 886 (6th Cir.1982) (on other than factual issues, court reviews to determine whether the order is arbitrary or capricious, whether there has been an abuse of discretion, or whether rational basis exists for a conclusion).

The Commission conceded that the apportionment of the proceeds sought by APS would have been preferable because it would have permitted investors and ratepayers to enjoy the benefits to which they would have been entitled if APS had used the tax benefits itself. The Commission found this goal unattainable, however, because of the significant problems with the apportionment proposals on the record, and found the ALJ's proposal superior to any of the others. In the absence of a clear congressional directive to the contrary, we will not reject the Commission's resolution of this issue. *See FPC v. United Gas Pipeline Co.*, 386 U.S. 237, 246, 87 S.Ct. 1003, 1008, 18 L.Ed.2d 18 (1967).

APS' last challenge to the Phase II decision is that the Commission erred in synchronizing the ratemaking treatment of the proceeds with the in-service date of Cholla No. 4. APS argues that synchronization is improper because it assumes that APS had use of the sales proceeds as of the in-service date in June, 1981, rather than almost six months later when they were actually received in November, 1981. Because the in-service date is the date at which the ratepayers were responsible for paying the costs attributable to the investment and the date at which APS earned the right to receive the tax benefits, the Commission did not abuse its discretion in ordering that the proceeds be amortized as of that date.

APA and the districts also challenge the synchronization of the proceeds. They contend, however, that the proceeds should have been amortized over the full year, rather than

one-half year as required by the Commission. The Commission's explanation for adjusting the test year estimates based on one-half year's amortization is reasonable, however; thus it does not constitute an abuse of discretion. *See Ohio Power,* 668 F.2d at 886.

Papago also challenges the Commission's ratemaking treatment of the proceeds of the Cholla 4 transaction. It argues in reliance upon *Midwestern Gas Transmission Co. v. FPC,* 388 F.2d 444 (7th Cir.), *cert. denied,* 392 U.S. 928, 88 S.Ct. 2286, 20 L.Ed.2d 1386 (1968), that the Commission erred in limiting the rate adjustment to the dollar value of the sales proceeds rather than the full value of the tax benefits to the ratepayers. In *Midwestern,* the utility had reverted from liberalized depreciation to straight-line when the FPC required it to flow-through the tax savings resulting from use of the former method to its ratepayers. The court found that management had chosen "the one method certain to result in maximum tax costs to themselves, with resulting maximum rates to the consumers," *id.* at 448, and that the resulting increased tax cost was not a "reasonable and prudent business expense" which the ratepayers could be required to bear. *Id.*

Papago contents that APS' sale of the tax benefits was imprudent under *Midwestern* because there was no legitimate business purpose for the sale. Papago claims that the sale would have been proper only if APS could not have used the ACRS deductions and ITCs to reduce its taxes in the future. Papago is unable to overcome the ALJ's finding that the transaction was not imprudent because one of Congress' major purposes in enacting the safe-harbor leasing provision was to make it perfectly legal for corporations, including APS, to transfer future potential benefits into current income. *See* "General Explanation of the Economic Recovery Tax Act of 1981," Staff of the Joint Committee on Taxation, at 103 (December 29, 1981), *reprinted in* Internal Revenue Acts, 1980-81, at 1478. We therefore decline to disturb the ALJ's exercise of his sound discretion in concluding that APS acted prudently in selling its tax benefits to General Electric.

The orders of the Commission in this case are AFFIRMED.

APPENDIX B

United States Of America
Federal Energy Regulatory Commission

Before Commissioners: Raymond J. O'Connor, Chairman; Georgiana Sheldon, J. David Hughes, A. G. Sousa and Oliver G. Richard III.

Arizona Public Service Company

Docket Nos. ER81-179-012, 013, and 014 (Phase II)

OPINION NO. 193-A

ORDER ON REHEARING

(Issued December 19, 1983)

In Opinion No. 193, 25 FERC ¶ 61,092 (1983), the Commission determined the appropriate ratemaking treatment of a $50.6 million lump-sum payment which Arizona Public Service Company (APS) received from General Electric Company (GE) when the two parties entered into a "safe harbor" transaction pursuant to the Economic Recovery Tax Act of 1981. We affirmed the presiding judge's conclusion that the proceeds should be amortized as a reduction to the utility's tax expense over the service life of the property involved (the Cholla No. 4 unit), with the unamortized balance being deducted from rate base. Applications for rehearing of our decision have been filed by APS, the Papago Tribal Utility Authority, the Districts[1] and Arizona Power Authority.

The rehearing applications raise no arguments not previously considered by the Commission. However, there are two matters which warrant discussion.

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[1]The Districts include Electrical District Nos. 1, 3, 6 and 7, Roosevelt Irrigation District, Buckeye Irrigation District, and Maricopa County Municipal Water Conservation District No. 1.

APS claims the Technical Corrections Act of 1982[2] enunciates a standard for the ratemaking treatment of safe harbor proceeds and that the Commission's action in Opinion No. 193 may jeopardize the availability of investment tax credits (ITC's) and Accelerated Cost Recovery System deductions (ACRS) for the Cholla No. 4 generating unit, as well as the use of the sale proceeds. We find the statutory language relied upon by APS to be ambiguous at best, and do not interpret it as mandating the Commission's ratemaking treatment of safe harbor proceeds.

The APS-GE safe harbor transaction took place pursuant to section 168(f)(8) of the Internal Revenue Code, which is entitled "Special rule for leases." Subsequent to the transaction, two pieces of legislation affecting that section of the Code were passed by Congress. First, the Tax Equity and Fiscal Responsibility Act of 1982[3] revoked the authority of public utilities to enter into safe harbor arrangements. A few months later, section 102(a)(10)(A) of the Technical Corrections Act of 1982[4] amended section 168(f)(8). Specifically, it amended subparagraph (D) of the section, which defines "qualified leased property." The amendment provides:

> (10)(A) Subparagraph (D) of section 168(f)(8) (relating to special rule for leases), as in effect before the amendments made by the Tax Equity and Fiscal Responsibility Act of 1982, is amended by adding at the end thereof the following new sentence: "*Under regulations prescribed by the* [*Treasury*] *Secretary, public utility property shall not be treated as qualified leased property unless the requirements of rules similar to the rules of subsection (e)(3)*[5] *of this section and section*

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[2]Pub. L. No. 97-448, 96 Stat. 2365 (1982).

[3]Pub. L. No. 97-248, 96 Stat. 342 (1982).

[4]Pub. L. No. 97-448, 96 Stat. 2365 (1982).

[5]Section 168(e)(3) mandates a normalization method of accounting for ACRS depreciation associated with public utility property.

> *46(f)*[6] *are met with respect to such property.*" (Emphasis added.)
>
> (B) The amendment made by subparagraph (A) shall apply with respect to property to which the provisions of section 168(f)(8) of the Internal Revenue Code of 1954 (as in effect before the amendments made by the Tax Equity and Fiscal Responsibility Act of 1982) apply.

APS ignores the obvious fact that nowhere in the above language or in any other part of ERTA is there any mention of how the *proceeds* from a safe harbor transaction are to be treated. The language refers only to the underlying public utility property. The only legislative history to guide us is the following Senate Report statement:

> The bill allows the Treasury Department to prescribe rules imposing normalization requirements with respect to public utility property that is subject to a safe harbor lease under section 168(f)(8).[7]

Again, there is no reference to the *proceeds* from a safe harbor transaction. Had Congress intended to mandate the ratemaking treatment of the proceeds themselves, we believe it would have done so in terms specifically referring to the proceeds.

At this time the Treasury Department has not issued any regulations pursuant to the Technical Corrections Act of 1982. Until such time as regulations are issued, this Commission will act to the best of its ability in determining appropriate ratemaking treatment consistent with the tax

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[6]Section 46(f) provides two options for ratemaking treatment of ITC's. Under option 1, the ITC is deducted from rate base, then restored to rate base over the economic life of the asset. Under option 2, the ITC is amortized to the cost of service over the economic life of the asset, with no deduction from rate base.

[7]S. Rep. No. 592, 97th Cong., 2d Sess., *reprinted in* 1982 U.S. Code Cong. and Ad. News 4153.

statutes enacted. The meaning of the amendment is unclear. Should the IRS issue regulations which indicate that our ratemaking treatment of the safe harbor proceeds themselves or the underlying ACRS and ITC's is contrary to the tax laws, we will at that time reconsider our decision. This is consistent with our decisions in other areas involving uncertainty in tax regulations.[8]

Even if APS' interpretation of the new legislation were correct, it would not support APS' original amortization proposal in this proceeding. This is because APS' proposal results in *no* deduction from rate base, but had the company kept the package of ACRS and ITC benefits, the ACRS portion of the benefits *would* have resulted in a reduction to rate base. Thus, even if we construed the statute as referring to ratemaking treatment of the proceeds, it would support the staff's position rather than APS'.[9] While we believe that theoretically the staff's general approach would be preferable because it would put both the investors and ratepayers in the same position they would have been in had APS itself been able to use the ACRS and ITC's, *based on this record* we were unable to conclude that any of the specific "split the proceeds" proposals is superior to the judge's recommendation. As pointed out in the testimony, briefs, and initial decision, all of the apportionment methods contain flaws.

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[8]See, *e.g., Natural Gas Pipeline Company of America,* Opinion No. 108, 13 FERC ¶ 61,266 (1981), wherein we approved a method by which the company was to recover a deferred tax deficiency. The company argued that the method approved would disqualify it from the continued use of accelerated depreciation. We rejected this argument and held that should the IRS issue a final revenue ruling concluding that Natural's tax accounting practices for ratemaking purposes contravene tax regulations as a consequence of the method approved by us, the Commission at that time would prescribe a remedy to bring Natural into lawful compliance with the tax laws.

[9]It is not clear whether APS has changed its position on rehearing. In footnote 6 of its petition, it states that the Commission must separate the proceeds into ITC and ACRS. APS previously advanced this argument as a secondary position, *i.e.,* the proceeds should be split only if the company's original proposal were not adopted.

Our major reasons for adopting the judge's decision in this docket were:

(1) According to both staff witnesses, the major portion of the proceeds is attributable to ACRS (69-81%). Pursuant to Commission Order No. 144, normalization of ACRS would result in a rate base reduction. To include all of the proceeds in rate base would be directly contrary to Order No. 144, particularly since most of the proceeds represent ACRS.

(2) As recognized in Order No. 144, a utility is entitled to recover from the ratepayers its cost of service plus an after-tax rate of return on the shareholders' investment. The proceeds here do not represent investor-financed rate base. The investment in the generating unit which was sold to GE is already in rate base and the ratepayers are paying return, depreciation allowance, and tax allowance on that investment. The investors therefore are already earning a return on the capital they have contributed. APS' proposal would allow the investors to earn a return on capital they did not contribute.

(3) The record supports a finding that the ratepayers will suffer a net loss as a result of the safe harbor transaction. It would be inequitable for them to bear this loan and in addition be required to pay a return on cost-free capital.

(4) The judge's proposal has nearly the same cost-of-service impact as that of staff witness Bublitz under his "split-the-proceeds" method.

In view of the above, and the infirmities in the apportionment methods presented herein, we affirm our conclusion that, based on this record, the judge's recommendation strikes the most equitable balance between the interests of ratepayers and investors.

Another matter raised on rehearing concerns our determination that the amortization of the safe harbor proceeds should be synchronized with the Cholla No. 4 in-service date, which was in June 1981. The Districts and

APA argue that amortization should be reflected for the entire test period. APS contends that the amortization should be synchronized with the date on which it actually received the proceeds, which was November 1981, and that any rate base reduction should be calculated on 13-point average. We reject both positions. APS began generating the tax benefits the date the plant came on-line. Therefore, the amortization should be synchronized with the in-service date.

The Commission orders:

The rehearing applications filed in this docket on November 18, 1983 are denied.

By the Commission. Commission Sheldon voted present. Commissioner Sousa dissented with a separate statement attached.

(S E A L)

KENNETH F. PLUMB,
Secretary.

Arizona Public Service Company

Docket No. ER81-179-012, 013 and 014 (Phase II)

(Issued December 19, 1983)

SOUSA, A.G., COMMISSIONER, *dissenting:*

For the reasons stated in my dissent in Opinion No. 193, *Arizona Public Service Company,* 25 FERC ¶ 61,092 (1983), I respectfully disagree with my colleagues' decision to deny APS' application for rehearing. However, although I do not believe that resolution of the issue here depends on the Treasury Department's issuance of regulations pursuant to the Technical Corrections Act, I am encouraged by the majority's decision to reconsider their position in the event such regulations are promulgated.

Also, I want to take this opportunity to reiterate that, in addition to splitting the "safe harbor" proceeds between ACRS deductions and ITC's, I would have approved a proposal to flow through the entire ITC portion to retained earnings. As I stated in my dissent to Opinion No. 193, I firmly believe that Congress intended investment tax credits to inure to the benefit of the shareholders in order to encourage investments. Hence, it is my opinion that a reevaluation of the Commission's policy on ITC's with respect to electric utilities is long overdue.

A.G. SOUSA
Commissioner

APPENDIX C

United States of America
Federal Energy Regulatory Commission

Arizona Public Service Company

Docket No. ER81-179-000 (Phase II)

OPINION NO. 193

APPEARANCES

Steven M. Wheeler, Brian J. McManus, and *Samuel Behrends* for Arizona Public Service Company.

Glen L. Ortman for Plains Electric Generation and Transmission Cooperative, Inc.

Arnold D. Berkeley and *Richard I. Chaifetz* for Papago Tribal Utility Authority.

James T. McManus and *Melvin Richter* for Arizona Power Authority, and Maricopa County Municipal Water Conservation District No. 1.

James C. Sabalos and *Joseph S. Koury* for the Staff of the Federal Energy Regulatory Commission.

United States Of America

Federal Energy Regulatory Commission

Before Commissioners: A.G. Sousa, Acting Chairman; J. David Hughes and Oliver G. Richard III.

Arizona Public Service Company

Docket No. ER81-179-000 (Phase II)

OPINION NO. 193

OPINION AND ORDER AFFIRMING INITIAL DECISION

(Issued October 19, 1983)

Phase II of this proceeding involves one issue: the appropriate ratemaking treatment of a $50,625,000 lump-sum payment which Arizona Public Service Company (APS) received from General Electric Company (GE) when the two parties entered into a "safe harbor" transaction pursuant to the Economic Recovery Tax Act of 1981 (ERTA).[1] This transaction involved the sale to GE of investment tax credits (ITC's) and Accelerated Cost Recovery System (ACRS) deductions stemming from APS' investment in its Cholla No. 4 generating unit.

Numerous proposals were made by the parties as to the appropriate treatment of APS' safe harbor proceeds. They are described in detail in an initial decision issued February 25, 1983. The presiding judge determined that the net present value of the costs the ratepayers will incur as a result of the safe harbor transaction is approximately $123.5 million. He concluded that the most just and eq-

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[1]Soon after ERTA was enacted, Congress in effect eliminated the ability of utilities to engage in these transactions.

uitable treatment of the proceeds would be to amortize the $50,625,000 as a reduction to the tax expense of the utility over the service life of the unit, with the unamortized balance being deducted from rate base.

APS, the Papago Tribal Utility Authority (PTUA) and Commission staff except to the judge's decision.

APS makes the following claims on exceptions: (1) The judge was wrong to adjust the Period II cost estimates in this proceeding to reflect the safe harbor transaction since it violates the Commission's test-year concept.[2] Furthermore, the effects of the transaction on the cost-of-service at issue are *de minimis*. (2) The judge erroneously computed the present value of the tax benefits sold and the effect on future revenue requirements. (3) Consideration of amounts other than the proceeds received from the sale was erroneous. (4) If the Commission deems it necessary to adjust the Period II cost-of-service, it should treat the proceeds at the wholesale level in the same manner as the Arizona Corporation Commission (ACC) did at the retail level.[3] (5) The ratemaking treatment recommended by the judge conflicts with the intent of Congress, in enacting ERTA, to enable companies that are unable to fully utilize the ITC and ACRS to receive the present value of those benefits instead. The proceeds should be treated in essentially the same manner as the underlying ITC and ACRS would have been treated insofar as normalization is concerned. (6) If the sale proceeds are to be split between

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[2]The safe harbor transaction occurred some ten and one-half months into Period II.

[3]The ACC ordered that the proceeds be ratably amortized over the remaining book life of Cholla No. 4 (approximately 29.3 years) by debiting cash and creating a miscellaneous deferred credit account on APS' balance sheet for the sale proceeds. The proceeds thus would be amortized "above the line" as a credit to income tax expense over the remaining book life of the plant. There would be no rate base reduction for the unamortized portion of the proceeds.

ACRS and ITC, as recommended by staff, then $25,000,000 should be assigned to ITC.[4]

PTUA has six major exceptions: (1) The judge erred in failing to find that the tax benefit transfer would cost APS ratepayers $443 million in additional rates over the life of Cholla 4, due to the loss of straight line depreciation taken as an operating expense for both rate and tax purposes.[5] (2) The scope of Phase II of this proceeding and the remedy herein does not have to be limited to the amount of the sale proceeds. APS has an obligation to protect the interests of its ratepayers where they conflict with those of its shareholders. (3) Once the loss to ratepayers has been valued, the next step should be to reduce rates by level amortization of the extra rate burden on the customers over the life of Cholla 4, and deduct from rate base the unamortized balance. Alternatively, the additional rates the ratepayers will be forced to pay as a result of the transfer over the life of the unit should be amortized, with the unamortized balance deducted from rate base. (4) The judge did not specify the method for calculating the unamortized balance to be deducted from rate base. The rates should be reduced by a level amount based on present value of additional revenue credits and a rate base credit of the unamortized balance. (5) The judge erred in not using a 10.63 percent discount factor to compute the present value of the lost benefits. (6) The judge erred when he decided to normalize ITC instead of flow it through.

The staff's exceptions are: (1) The judge erred in rejecting the basic methodology proferred by the staff witnesses which would split the proceeds into ITC and ACRS components based on a present value analysis. (2) The

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[4]APS' witness testified that the tax base of the property transferred to GE was $250,000,000, which produced an immediate ITC deduction of 10 percent, or $25,000,000 which GE used to reduce 1981 taxes.

[5]In its brief opposing exceptions, PTUA raised this figure to $491.75 million by adding to the $443 million another $48.75 million which it claims results from not using the ITC's that were sold to GE.

judge failed to synchronize the treatment of the proceeds with the time period Cholla 4 was in rate base during the test period.

We have reviewed the arguments and evidence herein, and conclude that the judge's decision should be affirmed.

Although there is considerable variation among the parties and the judge as to what net costs the ratepayers will incur as a result of the safe harbor transaction, it is clear that the ratepayers will suffer a detriment from the transaction in the long run. Even APS, who alleges numerous omissions and flaws in the figures calculated by the judge and other parties, concludes in its brief on exceptions that the net present value of costs the ratepayers will incur is $82.6 million.[6] We need not reach an exact calculation since we affirm the judge's decision to adjust APS' cost-of-service only insofar as the actual $50,625,000 in proceeds is concerned. The question before us is how to equitably apportion those proceeds between investors and ratepayers, in view of the fact that the ratepayers will suffer a substantial loss as a result of the transaction.

First, we will address APS' argument that no adjustment should be made at all to the cost-of-service in this proceeding. This argument was properly rejected by the judge at pages 12-13 of his decision. The Commission has made exceptions to its traditional adherence to the test-year concept in cases where there are known and measurable changes of a substantial nature.[7] That is the case here. As to APS' contention that the amount involved here is *de minimis*, this argument is not supported on the record herein since APS made its calculations based on the approach used by the ACC and included the proceeds for only approximately six weeks of the test period. Additionally, it would be unfair to the ratepayers not to con-

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[6]Although APS claims the $82.6 million is offset by other factors, it fails to quantify such an offset.

[7]*Virginia Electric and Power Co.*, 10 F.E.R.C. ¶ 61,083 at 61,180-81 (1980), *aff'd*, Opinion No. 118, 15 F.E.R.C. ¶ 61,052 at 61,108 (1981).

sider the proceeds in this proceeding since they are carrying the cost of the plant for half the test period.

The major dispute as to treatment of the $50,625,000 is whether the unamortized proceeds should be deducted from rate base, as allowed by the judge. APS claims that if the proceeds are deducted from rate base, the ratepayers will benefit at the expense of the shareholders since the capital for construction of Cholla No. 4 came from the investors, not the ratepayers. The key to determining whether there should be a reduction in rate base, claims APS, lies in the assumption that the ratepayers contributed the capital. In support of its position APS primarily relies on *New England Power Co.*, Opinion No. 49, 8 F.E.R.C. ¶ 61,054 (1979) (*NEPCO*), *aff'd sub nom, NEPCO Municipal Rate Committee v. F.E.R.C.*, 668 F.2d 1327 (D.C. Cir. 1981), *cert. denied*, 102 S.Ct. 2929 (1982), and *Wisconsin Power and Light Co.*, Opinion No. 141, 19 F.E.R.C. ¶ 61,288 (1982). It attempts to analogize the ACC approach (the approach APS advocates) to the Commission's policy requiring losses on cancelled plants to be shared by ratepayers and investors.

APS' reliance on the *NEPCO* and *Wisconsin* cases and its attempted analogy to cancelled plants are misplaced. In *NEPCO*, the Commission allowed the utility to amortize to the cost-of-service its entire investment in a cancelled generating plant, but denied rate base treatment of the unamortized amount. It rejected the argument that investors should be fully insulated from all risks and concluded that ratepayers should have to pay a return only on investments in properties that are used and useful to them. An important distinction between that case and this one is that in *NEPCO*, the cancelled plant was removed from rate base, whereas in this case the $250 million original cost of Cholla 4 remains in rate base as plant in service.[8] In *NEPCO*, the Commission focused on whether ratepayers should have to pay a return on plant which would never be used and useful. In contrast, the used and useful issue

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[8]Tr. 2990.

never arises in this case because the plant is already in service.

The *Wisconsin* case also is distinguishable. In that case, the utility lost part of its plant due to an ice storm. The issue was how to equitably apportion the loss between ratepayers and investors. The Commission followed the *NEPCO* procedure and allowed the utility to recover the undepreciated balance of the loss through the rates over a five-year period, but did not allow it to earn a return on the loss. Although the case did not involve a plant that was never put in rate base, it presented a quite different factual situation than here, and it is difficult to see how it supports APS' position since it followed *NEPCO* in removing amounts from rate base.

In support of its position, APS stresses the fact that the safe harbor proceeds are not ratepayer-contributed capital. The issue, however, is not whether the proceeds were contributed by the ratepayers, but whether the proceeds were contributed by the *investors*. In *Distrigas of Massachusetts Corp.*, Opinion No. 178,[9] the Commission recently affirmed an initial decision which aptly summarized the principle involved here:

> Time-honored precedent recognizes a utility's right to earn a fair return on investor-contributed capital (rate base). It follows then that a utility is not entitled to earn a return on that portion of rate base financed by sources other than the owner's capital. *See, e.g., Canadian River Gas Company,* 3 FPC 32 (1942) . . .[10]

This principle is also reflected in the Commission's Order No. 144 rulemaking on tax normalization, in which we stated:

> . . . The deferred taxes represent a cost-free form of financial capital to the utilities. The deduction

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[9]23 FERC ¶ 61,416 (1983).

[10]18 FERC ¶ 63,036 (1982) at 65,112.

> of accumulated deferred taxes from rate base is not intended to provide customers with a return on funds loaned to utilities. Rather, as a number of parties have correctly pointed out, it is simply a way of reflecting the fact that a certain portion of rate base is not financed by investor funds so that there is no 'interest' cost to the utility on a portion of its rate base. There is no 'interest' cost that requires collection in rates.[11]

The safe harbor proceeds likewise to not represent investor-contributed capital. Rather, as pointed out by PTUA and recognized by the judge, they arose as a result of selling tax benefits arising from public utility property on which the ratepayers pay APS a return, depreciation allowance and tax allowance.

APS' other major argument in support of the ACC method is that the $50,625,000 received from GE merely represents the tax benefits in another form and therefore the proceeds should be treated in essentially the same manner as the underlying ITC and ACRS would have been treated insofar as normalization is concerned. This argument is puzzling because the ACC method provides no deductions from rate base, thereby treating the entire proceeds as coming from ITC. If the ITC and ACRS benefits had been retained, however, the ACRS portion would have resulted in a rate base deduction. Thus, even under APS' own theory, the entire $50,625,000 should not be included in rate base.

The judge's recommendation to remove the unamortized balance of the proceeds from rate base is consistent with our previous adherence to the principle that investors should earn a return only on the capital they contribute. It also recognizes that APS' ratepayers have lost substantial tax benefits and will suffer a net loss as a result of the safe harbor transaction. We need not speculate on

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[11]Docket No. RM80-42, *et al.*, Order No. 144 (May 6, 1981), mimeo at 60-61.

the precise amount of the extra costs the ratepayers will incur since we are adjusting the cost-of-service only insofar as the proceeds themselves are concerned. As to the various arguments by all parties concerning Congressional intent in enacting ERTA, we agree with the judge's conclusion at page 17 of his decision that there is no real basis for interpreting a Congressional intent to preclude the rate treatment allowed herein.

The Commission staff admits in its brief on exceptions that the methodology adopted by the judge is not unreasonable, but claims that its basic methodology is superior. The parties have pointed out a number of shortcomings in the staff proposals which we need not go into here. Suffice it to say the staff's proposals have not been shown to be superior. We believe the judge's recommendation strikes an equitable balance between the interests of the ratepayers and investors. Accordingly, the initial decision is affirmed with one clarification discussed below.

The staff excepts to the judge's failure to synchronize rate treatment of the safe harbor proceeds with the time period Cholla No. 4 was in rate base during the test period. We agree with the staff's argument. The tax benefits associated with depreciation on the unit were included for approximately one-half the test period. Had there been no safe harbor transaction, the ratepayers would have received tax benefits associated with one-half years' depreciation on the unit. Therefore, amortization of the $50,625,000 should be synchronized with the Cholla 4 in-service date.

One further matter needs to be addressed. On May 9, 1983, APS filed a motion to strike pages 42-44 and Appendix A of PTUA's brief on exceptions. It claims this material represents new arguments, evidence and computations that were not previously put forward in the proceeding, accepted into the record, or subjected to cross-examination. The material relates to PTUA's proposal for calculating the unamortized balance of sales proceeds to be deducted from rate base.

According to APS, it was never confronted with the position and arguments raised in the disputed material until receipt of PTUA's brief on exceptions. PTUA, however, points out that an identical Appendix A and explanation of the calculations were contained in its reply brief to the judge, and that all of the figures used are contained in or derived from figures in the record. PTUA also cites to portions of the record in which its witness testified concerning the unamortized balance of the proceeds.

We find good cause to grant APS' motion to strike. Although the disputed material was presented to the judge in PTUA's reply brief, and the calculations may have been derived from various parts of the record, the arguments made and the precise form of the calculations are not specifically contained in the record and the figures and the bases for selecting them were not subjected to cross-examination by the parties.[12] To consider PTUA's arguments based on such evidence would prejudice other parties to the proceeding. In any event, our review of the material indicates it would not change our decision herein.

The Commission orders:

(A) The initial decision issued in this proceeding on February 25, 1983, is affirmed and adopted to the extent not modified herein. Any exceptions to the decision not granted herein are denied.

(B) Within 75 days of the date of issuance of this order, APS shall file a revised cost-of-service and any necessary amendments to its rate schedules or tariffs, in lieu of those at issue herein, in accordance with the findings and conclusions of this decision and with the Commission's Rules and Regulations. However, if applications for rehearing are pending at the close of the 75-day period, the above-mentioned filing shall be made 30 days from the date the

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[12]APS claims Appendix A contains substantive errors, such as the fact that it appears to include non-rate base related revenue requirements.

applications for rehearing are disposed of by the Commission.

(C) Within 30 days of the Commission's approval of the revised tariff sheets, APS shall refund to its customers, with interest, any amounts collected in excess of those allowed herein. Within 15 days thereafter APS shall file a report showing the computation of the refunds and interest paid. A copy of the refund report shall also be sent to all state utility regulatory agencies in states with customers affected by this order.

(D) APS' May 9, 1983 motion to strike is granted.

By the Commission. Commissioner Sousa dissented with a separate statement attached.

(S E A L)

KENNETH F. PLUMB,
Secretary.

Arizona Public Service Company

Docket No. ER81-179-000 (Phase II)

(October 20, 1983)

SOUSA, A.G., ACTING CHAIRMAN, *dissenting:*

I respectfully disagree with my colleagues' conclusion that APS' safe harbor proceeds should receive ratemaking treatment as if those proceeds were attributable entirely to ACRS deductions. It is undisputed that some of those proceeds were attributable to ITC's received by APS for its investment in the Cholla No. 4 generating unit. Although my colleagues agree with Judge Benkin's assessment that splitting the proceeds would be based on a legal fiction, I believe that ignoring the uncontroverted dual nature of those proceeds is similarly grounded in fiction. Therefore, it would be reasonable to assign a portion of the proceeds to each of the tax benefits.

I appreciate that the transaction between APS and General Electric was such that determining a perfect split is difficult. However, the Commission is frequently asked to make difficult decisions involving the balancing of seemingly conflicting interests. In this case, my colleagues have decided to avoid making such a decision. I believe, however, that it is incumbent upon them and myself to determine a split in order to attempt to put the investors and ratepayers of APS in the same position they would have been in had the sale not occurred. In that way, we would better effect the Congressional intent of ERTA to encourage investment and capital formation, while at the same time not unfairly penalizing either the investors or the ratepayers. For my part, I find APS' seemingly uncontroverted testimony persuasive—$25 million should be assigned to ITC's since the tax base of the property transferred to GE was $250 million, which produced an immediate ITC deduction of 10 percent, which GE used to reduce 1981 taxes.

I have one other concern that needs to be articulated. Underlying Judge Benkin's decision, which my colleagues have affirmed, is the proposition that APS' proposed treatment in regard to the ITC portion of its safe harbor proceeds somehow unduly deprives the ratepayers of their fair share. On the contrary, what APS proposed was no more than the cost-of-service option provided by ERTA and codified in the Internal Revenue Code whereby a public utility taxpayer may give the ratepayers some benefit from its investment tax credits. I find no fault with APS' proposed treatment. In fact, I would have found no fault with allowing complete flow through of the ITC portion to retained earnings. I firmly believe that Congress intended investment tax credits to inure to the benefits of the shareholders in order to encourage investments. In this regard, I will continue to urge my colleagues to pursue a reevaluation of the Commission's policy on ITC's with respect to electric utilities. *See Southwestern Public Service Co.*, Opinion No. 162, 22 FERC ¶ 61,341 (1983) at 61,587.

A.G. SOUSA
Acting Chairman

APPENDIX D

United States Of America

Federal Energy Regulatory Commission

Arizona Public Service Company

Docket No. ER81-179-000
(Phase II)

INITIAL DECISION ON TREATMENT OF "SAFE HARBOR" PROCEEDS

(February 25, 1983)

APPEARANCES

Steven M. Wheeler, Brian J. McManus, and *Samuel Behrends* for Arizona Public Service Company.

Glen L. Ortman for Plains Electric Generation & Transmission Cooperative, Inc.

Arnold D. Berkeley and *Richard I. Chaifetz* for Papago Tribal Utility Authority.

James T. McManus and *Melvin Richter* for Arizona Power Authority, and Maricopa County Municipal Water Conservation District No. 1.

James C. Sabalos and *Joseph S. Koury* for the Staff of the Federal Energy Regulatory Commission.

BENKIN, *Presiding Administrative Law Judge:*

In this second phase of a multi-issue electric rate case, the Commission must determine the appropriate ratemaking treatment of the proceeds of a jurisdictional electric utility's sale of tax depreciation and investment tax credits in a so-called "safe harbor" transaction. An initial

decision in the first phase of the case, disposing of the remaining litigated issues, was issued on October 15, 1982.[1]

"Safe harbor" transactions are the child of the Economic Recovery Tax Act of 1981, ERTA, which added to the Internal Revenue Code a new section 168(f)(8), legitimizing, for tax purposes, arrangements under which the owner of a newly-acquired capital asset could, in effect, sell the accelerated tax depreciation and investment tax credits that result from his investment in the asset and still retain all the other incidents of ownership. The form of the transaction, as authorized by the ERTA amendments to the Code, was a sale of the asset to a "buyer" (who presumably could make more remunerative use of the tax deductions and credits associated with the asset than the owner could), coupled with a lease back to the putative "seller" of all of the attributes of ownership except the tax benefits.[2] In the same measure, Congress provided for substantially more liberal rules for depreciating assets for tax purposes, under a method denominated the Accelerated Cost Recovery System (ACRS), thereby increasing the potential value of tax depreciation as a source of ready cash and making the sale of these tax benefits more expedient and, in the view of some, more lucrative. Eventually, the concept of permitting businesses to traffic in income tax deductions and credits became so fiscally and politically unpalatable that, a year after ERTA was enacted, Congress largely repealed the statutory authority for the "safe harbor" leasing schemes—at least as applied to "pure" sales of tax benefits, with no other economic substance to the transactions.[3] But that is another story.

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[1] *Arizona Public Service Co.*, Docket No. ER81-179-006 (Phase I), "Presiding Administrative Law Judge's Initial Decision on Proposed Wholesale Electric Rate Increase," 21 FERC ¶ 63,007 (hereinafter cited as "Phase I Decision").

[2] *See* § 201 of Pub. L. 97-34, 95 Stat. 203, 214 (1981).

[3] *See* § 209 of the Tax Equity and Fiscal Responsibility Act of 1982, 96 Stat. 324, 442.

On November 12, 1981, Arizona Public Service Company (APS) entered into a "safe harbor" agreement with General Electric Company, under which APS transferred to General Electric the right to take depreciation deductions under the Accelerated Cost Recovery System and investment tax credits stemming from APS' investment in its Cholla No. 4 generating unit. The Cholla No. 4 unit had gone into service in June of 1981.[4] Under the terms of the agreement (Exhibit No. 107), General Electric paid APS $50,625,000 in cash at the time the contract was executed and promised to pay the balance of the "purchase price" of $250,000,000 (an amount equal to APS' adjusted basis of the Cholla No. 4 unit for tax purposes) in installments over the 42-year life of the lease. However, the periodic installment payments were exactly offset by amount of the rental payments that APS was obligated to make for the lease-back of the unit. This being so, the contract expressly provided that both General Electric's purchase-price installments and APS' rent payments "shall each be treated as having been paid automatically and without any action by either party."[5] At the end of the 42-year term of the lease, ownership of the Cholla No. 4 unit automatically vests in APS.

As a consequence of the safe harbor transaction, APS received a lump sum of $50,625,000. As indicated above, the principal issue in this case is to decide how to treat that sum for ratemaking purposes. There were, however, other financial consequences to the transaction. For one thing, APS transferred to General Electric, and thereby irretrievably lost for itself and its ratepayers, the right to take deductions under the Accelerated Cost Recovery System and investment tax credits on its income tax returns that could total $250 million and $25 million, respectively. In addition, the installment payments by General Electric and the "rent" payments by APS, though equivalent in amount, give rise to an annual tax deduction for APS.

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[4]See Phase I Initial Decision, p. 5.

[5]Exhibit No. 107, p. 4.

This is the case because each of APS' "rent" payments is fully tax-deductible, while only the interest portion of the installment payments received from General Electric is includable in the utility's gross income for tax purposes. The difference (theoretically representing payments of principal upon the purchase price) generates deductions for APS amounting to $31,000 in the first year of the lease and increasing every year thereafter until, in the 42nd, or final, year of the lease, APS will have an income tax deduction (assuming no change in the tax laws) of $30,992,000.[6]

Since the negotiations and agreement with General Electric took place long after APS filed its rate-increase proposal in this docket, neither the transaction nor its financial consequences were reflected in the filing or the evidence the utility submitted to support the filing. News of the transaction first appeared on the record during the examination of the company's Executive Vice President and chief financial office, Henry Sargent, less than one week after the agreement was signed. A motion by counsel for intervenor electrical districts to file supplemental testimony of the districts' witness Richard L. Darnall on the issue of ratemaking treatment of the proceeds of the transaction was granted, and the company was given leave to file testimony of a witness in rebuttal to Darnall's views.

All of this was done rather hurriedly. After the record closed, the Commission Staff Counsel filed a motion, asking to have the record reopened for the purpose of receiving additional evidence about the proper ratemaking treatment of the proceeds of APS' sale of investment tax credits and tax depreciation deductions to General Electric. At a March 17, 1982 conference convened to discuss the Staff motion, APS objected to reopening the record on the ground, *inter alia*, that delay in concluding the proceeding would be prejudicial to its interests, especially because its wholesale customers included parties whose rates could not be changed until after the Commission took final

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[6] *See* Exhibit No. 111.

action in this docket under the provisions of section 206 of the Federal Power Act. However, counsel for all parties, including the so-called section 206 customers, entered into a stipulation, under which the Commission's final disposition of the remaining issues would be allowed to go into effect for all of the customers (including the section 206 customers), if the Commission acted on those issues before it disposed of the question to which the Staff's motion was directed. In light of the stipulation's removal of the possibility that an additional hearing might prejudice APS' interest in putting its revised rates fully into effect, and because the treatment of the proceeds of the General Electric transaction seemed to pose an important question of first impression that should be decided on as complete a record as possible, I issued an order relegating that question to a Phase II of the proceeding and reopening the record for the receipt of additional evidence bearing on the question.[7]

In due course, additional evidence was filed and further hearings were held, lasting from May 18 to May 21, 1982. Evidence was filed by APS, the Commission Staff, the Papago Tribal Utility Authority (PTUA), and the Electrical Districts and Arizona Power Authority. Plains Electric Generation & Transmission Cooperative, also a wholesale customer, participated in the reopened proceeding and filed a brief in support of the joint Electrical Districts-APA position.

The parties' proposed solutions to the problem of how to treat the proceeds of the sale of the utility's ACRS deductions and investment tax credits span a rather broad gamut. At one baseline are the alternative suggestions of APS that the Commission should simply ignore the transaction, at least in this case, or should adopt the same resolution as was ordered by the Arizona Corporation Commission: the $50,625,000 received from General Elec-

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[7] "Presiding Administrative Law Judge's Order Phasing Proceeding, Reopening the Record, and Setting Procedural Dates," issued March 19, 1982 (unreported).

tric should be amortized as a credit to income tax expense on a straight-line basis over the remaining book life of the Cholla No. 4 facility (a little less than 30 years) without any deduction of the unamortized proceeds from rate base during that time.

Somewhere in the middle of the spectrum are proposals that call for apportioning the proceeds of the transaction into two segments, one attributable to the sale of ACRS deductions and the other attributable to the sale of investment tax credits. The purpose of the apportionment, as we shall see, was apparently to attempt to treat the proceeds of selling the tax benefits in a manner akin to the tax treatment APS would have received if the benefits had been retained.

The Commission Staff sponsored two alternative (and mutually inconsistent) methods of making the apportionment. M. Wayne McDanal of the Commission's Office of Chief Accountant, developed a model, a series of calculations, showing how, in his judgment, APS would have used the ACRS deductions and the investment tax credits stemming from ownership of Cholla No. 4 if the company had eschewed the safe harbor transaction. He then performed a present-value calculation of each of the two streams of future benefits (using a 12.87% discount rate)[8] and found that they totaled $50,525,036. The present value of the ACRS deductions accounted for 81.3% of this total, while the balance, 18.7%, was attributable to the investment tax credit component of the benefit stream. Hence, McDanal proposed to allocate 81.3% of the sale proceeds, or $41,158,125, to the sale of ACRS deductions and 18.7% of the proceeds or $9,466,875, to the sale of investment tax credits. The $41,158,125, McDanal said, should be

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[8]The 12.87% figure is the overall rate of return allowance the company had sought in its filing. *See* Exhibit No. 1, Statement G, p. 1. The Phase I Decision set the rate of return allowance at 12.76%, but of course McDanal could not have known that when he filed his testimony. What he did know (or should have known) was that Staff's rate-of-return witness was recommending an overall return allowance of 12.30%. *See* Exhibit No. 62, Revised Schedule 43. His reasons for refusing to use her recommendation can only be surmised.

treated as if it were an accumulated deferred income tax balance. Under this proposal, the entire amount would initially be deducted from the rate base. Thereafter, one-thirtieth of the amount ($1,371,938) would be added to the rate base each year during the 30-year economic life of the plant. As for the $9,466,875 of proceeds that he attributed to investment tax credits, McDanal said that this amount should be amortized ratably to cost of service over the economic life of Cholla No. 4; that is, the company's tax expense each year should be reduced by one-thirtieth of that sum for the next thirty years, with no deduction from rate base during the interim. This proposal mirrors one of the two methods that the Internal Revenue Code allows a public utility taxpayer to use to give the ratepayers some benefit from its investment tax credits. *See* Internal Revenue Code § 46(f)(2).

A second allocation theory was advanced by Staff witness Christopher J. Bublitz of the Commission's Office of Electric Power Regulation. Bublitz's principal disagreement with his colleague centered around the proper method of apportioning the proceeds of the safe harbor sale between those attributable to the sale of ACRS benefits and those attributable to the sale of investment tax credits. It was Bublitz's position that, in performing the apportionment, one must "attempt to value the stream of tax benefits that accrue to the owner of Cholla IV from the perspective of GE and APS . . ." Exhibit No. 130, p. 4. Bublitz assumed that General Electric would adopt a 20% discount rate, or internal rate of return, to calculate the present value of the stream of tax benefits and would also base its evaluation upon the assumption that all benefits could be used at the earliest time allowed by law.[9] Bublitz

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[9]The question of the timing of tax benefit use arises because of two factors. First, the Internal Revenue Code limits a taxpayer's use of investment tax credits to 80% of the taxpayer's taxable income. Hence, a taxpayer may have so large an investment tax credit coming to him as to be unable to use all of it during the tax year because of the 80% limitation. In that event, the unused credit amounts are carried forward for use during future years. *See* Phase I Decision, 21 FERC ¶ 63,007

concluded that from the standpoint of General Electric, the Cholla No. 4 tax benefits would have a net present value of $71,139,924, with 35.142% of that sum related to investment tax credits and the remaining 64.858% related to ACRS deductions. Turning to APS, Bublitz concluded that the Cholla No. 4 tax benefits would have a net present value of $58,262,571, 26.1159% of which was related to investment tax credits and 73.8841% of which was related to ACRS deductions. In making these latter evaluations, Bublitz assumed that an 18% discount rate was appropriate for APS and that the utility would not be able to use either the investment tax credits or the ACRS deductions attributable to the investment in Cholla No. 4 before tax year 1984. *See* Exhibit No. 130, p. 5.

Bublitz's final apportionment figures were simply the product of averaging the percentages he had assigned to both parties to the transaction. The amount assigned to the sale of investment tax credits was $15,505,931, 30.629% of the $50,625,000 that General Electric paid to APS. The figure of 30.629% was selected because it is the average of the 26.1159% of the proceeds that were attributed to investment tax credits, looking at the transaction from the APS standpoint, and the 35.142% of the proceeds that Bublitz said were attributable to investment tax credits when the transaction was viewed from the utility's perspective. The balance of the proceeds, $35,119,069, was determined to be attributable to the sale of ACRS benefits.

The latter sum, Bublitz said, should be amortized over the service life of Cholla No. 4, with the annual amorti-

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at p. 65,083, for a discussion of the impact of the 80% limitation on APS. The second factor that might affect a taxpayer's use of tax benefits is the axiomatic proposition that tax depreciation, as well as any other deduction, is of value only to the extent the taxpayer has net taxable income to be sheltered by the deduction. The availability of net income may not seem like a risky assumption in the environment of a regulated public utility, but in the unregulated world in which General Electric functions, things are often colder, crueler, and less sanguine.

zation used to reduce income tax expense in APS' cost of service. Under Bublitz's theory, the amount attributable to investment tax credits could be treated in accordance with either of the two options that the Internal Revenue Code provides for investment tax credits: (1) It could be deducted from rate base and restored ratably to rate base over the economic life of Cholla No. 4, in accordance with section 46(f)(1) of the Code; or (2) It could be amortized as a credit to the utility's income tax expense over the economic life of Cholla No. 4, with no reduction of rate base, in accordance with section 46(f)(2) of the Code.

The third of the advocates of apportionment was Richard L. Darnall, who returned to testify a second time on behalf of Arizona Power Authority and the Electrical Districts. Darnall's analysis began with the fact that the gross amount of investment tax credits APS could have secured if it had retained the Cholla No. 4 tax benefits amounted to $25 million. In addition, the record during the Phase I hearing indicated that if APS had retained the right to those credits, it would have used them to reduce its Federal income tax liability over a four-year period. Accordingly, Darnall recommended that $25 million of the safe harbor proceeds should be charged to income over four years, an action that would have the effect of reducing the cost of service by $6,250,000 per year. Under Darnall's theory, there would be no reduction in rate base during the period of amortization of the $25 million. Left unanswered in Darnall's testimony was the question of what, if any, disposition should be made of the $25,625,000 of the proceeds Darnall (at least by negative implication) attributed to the sale of ACRS deductions.[10]

Darnall concluded his testimony by proposing an alternative method of handling the proceeds of the safe harbor

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[10]In a footnote to their initial brief, the Districts and APA say that "the portion of the proceeds left after adjustment for the $25,000,000 ITC benefits obviously should be normalized over the book life of Cholla 4." p. 5, n.2. The difficulty with this statement is that the position taken is far from obvious, and is simply unsupported by anything in the record.

transaction for rate purposes. He suggested that the entire amount of the proceeds—without any apportionment—should be amortized as a credit to the cost of service over the economic life of Cholla No. 4. This is essentially the same resolution as APS seeks. However, Darnall also advocated deducting the unamortized balance of the proceeds from the utility's rate base, a step APS has vigorously resisted. The proof of the validity of this additional step, Darnall pointed out is that it would increase the present value of the treatment to the ratepayers from $20 million under the company's proposal to approximately $49 million, a figure more in line with the sum that APS secured from General Electric.[11]

PTUA's position is that the appropriate treatment of the proceeds of the safe harbor transaction must begin with an assessment of what the company gave up in order to secure them. This kind of assessment must be made in order properly to weigh and balance the respective interests of the utility and its ratepayers.

The evidence submitted by PTUA, through its witness Anis D. Sherali, indicates that the cost to the ratepayers resulting from the sale-and-leaseback transaction far exceeded the benefits to them or, indeed, the benefits to APS. The precise figures are rather difficult to come by in the record, and PTUA has not made matters any easier by repeatedly changing its calculations as its explication of its position evolved. But the order-of-magnitude differential between what APS got from General Electric and what it bargained away has enduring validity despite the best efforts of the utility to undermine it or explain it away.

The costs fall into a number of categories. First, of course, is the loss of ACRS deductions on the $250 million investment in Cholla No. 4. Sherali calculated the present value (*i.e.*, as of 1981) of those deductions was

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[11]Tr. 2933.

$52,244,000.[12] In addition, the company disposed of the right to investment tax credits by virtue of its investment in the power plant. Sherali said that the $25,000,000 worth of credits APS gave up would have a present value (again, assuming an 18% discount rate) of $12,599,000. Hence, said Sherali, APS surrendered tax benefits having a present value of $64,843,000. But it also *gained* some tax benefits as a result of the safe harbor transaction. As noted above, the contract obligated APS to make an annual rental payment to General Electric in an amount ($33,922,000) that is exactly equal to General Electric's obligation to make annual installment payments to APS. Because the rental payments are tax-deductible in their entirety while only the interest element of the installment payments are includible in taxable income, APS realizes an annual net tax deduction equal to the difference between these two amounts. According to Sherali, that stream of tax deductions during the 42-year life of the transaction has a present value of $1,377,000 and will produce a stream of tax savings having a present value of $673,000 to APS.[13] These tax savings must be deducted from the tax costs in assessing the overall impact of the safe harbor transaction, said Sherali. Hence, it was his conclusion that "the present value in 1981 dollars of total net loss in tax benefits resulting from the sale of tax benefits is $64,170,000. Since APSC only received $50,625,000 for the sale of tax benefits, benefits amounting to $13,545,000 expressed in 1981 dollars were lost by APSC as a result of this transaction."[14]

The net loss to the ratepayers, was somewhat less, Sherali conceded. Although the $25 million in investment tax credits attributable to Cholla No. 4 would have been used to reduce APS' tax liability in 1983 and 1984, if the utility

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[12]This calculation made use of an 18% discount rate. The source of that figure will be discussed *infra*.

[13]The $673,000 is the product of multiplying $1,377,000 by the APS statutory tax rate of 48.869%.

[14]Exhibit No. 110, p. 6.

had retained the credits, the reduction in the utility's tax expense element of its cost of service would have been spread over a much longer time period. As we have noted, the Internal Revenue Code requires public utilities to normalize investment tax credits attributable to investment in recovery property. Assuming use of the normalization technique sanctioned by section 46(f)(2) of the Code—ratable amortization without reduction of rate base—the ratepayers would have received the benefit of the tax credits through a $962,000-per-year reduction in the company's annual income tax expense for 26 years, Sherali pointed out. He calculated the present value of that stream of benefits (again using an 18% discount rate) as $3,786,000.

So Sherali concluded that the net present value of the tax benefits lost by the APS ratepayers as a result of the deal with General Electric amounted to $55,357,000 ($52,244,000 + $3,786,000 - $673,000). This conclusion was erroneous, however. The error consisted in Sherali's failure to provide for normalization of the ACRS deductions in computing the tax allowance component of the cost of service. As all sides appear to recognize, if APS had retained the ACRS deductions stemming from its Cholla No. 4 investment, the utility would have been required to normalize the effect of those deductions on its income tax expense. *See* 18 CFR 35.24 (1982) and the discussion of this subject in the Phase I Decision, 21 FERC ¶ 63,007 at pp. 65,086-089. As a result, the ratepayers would have received the benefit of those deductions over the 30-year economic life of the plant rather than the 15-year period during which it would have been written off for tax purposes under the Accelerated Cost Recovery System. Sherali, however, performed his calculations of ratepayer impact based upon a 15-year, rather than a 30-year, write-off period.

APS witness Paul A. Williams calculated the present value of ACRS deductions foregone as a result of the safe harbor transaction as $44,093,000. *See* Exhibit No. 116. Counsel for PTUA, in his reply brief, gives the figure as

$44 million.[15] Using the figures that appear in PTUA's brief (at p. 25), purporting to show the annual increase in APS' tax expense owing to the unavailability of normalized ACRS deductions attributable to investment in Cholla No. 4, I calculate a present value of $44,934,978 for that stream of benefits.[16] It appears, therefore, that PTUA's figure of $44 million is accurate enough for our purposes and may be accepted as the present value of the ACRS deductions that were sold to General Electric.

If we adjust Sherali's calculations by substituting the $44 million figure for the value he used, we come to the conclusion that the net present value of the tax benefits transferred by APS, in terms of resultant increases in its cost-of-service tax expense amounts to approximately $47,113,000 ($44,000,000 + $3,786,000 - $673,000). Limiting our consideration to the effect on APS' tax expense, therefore, the receipt of $50,625,000 of cash in hand seems a more than ample *quid pro quo* for the sale of tax benefits having a $47,113,000 impact on the cost of service. This is what APS claims. And the utility goes on to point with pride at a number of other alleged salutory effects of the safe harbor transaction. For one thing, says APS, the transaction gave the company a large lump sum that it did not have to borrow at a time of extraordinarily high interest rates. Testimony of APS witness Williams indicated that if APS had gone to the financial markets to borrow $50 million during the Fall of 1981, it would have been compelled to pay an interest rate of 18 percent.[17] In

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[15]*See* p. 3 of the brief. The difference between the two calculations may be caused by the fact that whereas PTUA used the statutory incremental income tax rate of 48.869% uniformly, APS insisted that the appropriate tax rate for the first year, 1981, was the company's effective overall tax rate for that year, 16.814%.

[16]The table has built into it, the use of a uniform tax rate of 48.869%. I used a discount rate of 18% throughout.

[17]Tr. 3039; Exhibit No. 115, p. 7. This is the source of the 18% discount rate that several of the witnesses used for performing present-value analyses. In light of what has happened to financial markets since the date of the hearing, that rate seems to be on the high side. It

addition, the utility claims that the transaction improved its future financing flexibility, reducing its embedded cost of debt and debt ratio and increasing its coverage ratio. This will make it easier to raise capital in the future, should the need arise to do so, according to APS.

If the loss of ACRS and investment tax credit benefits were the end of the story, it would be tempting to accept the company's argument that, on balance, the safe harbor transaction was entirely beneficial to the interests of the ratepayers. But there are additional factors that have to be taken into consideration. In the first place, the $44 million present value of foregone ACRS deductions noted above constitutes only the increase in the company's income tax allowance during the economic life of Cholla No. 4 owing to the sale of the ACRS deductions attributable to APS' investment in that generating facility. In order to increase the company's revenues enough to provide it with the wherewithal to pay the additional tax liability, however, APS' rates must be adjusted so that it will receive those revenues net of taxes on the income. There is, in other words, a "tax-on-tax" effect that must be accommodated. The ratepayer payments to cover the utility's additional tax liability are themselves taxable income to the utility. This means that in order to provide APS with the revenues to cover $44 million worth of additional tax expense, the ratepayers will have to sustain an increase in their rates having a present value of some $85.8 million, since revenues must increase by approximately $1.95 before taxes to provide the utility with an additional dollar after taxes.[18]

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should be noted, however, that if a lower discount rate is used, the impact is a "tilt" in favor of the PTUA position and against the position of APS: the present value of the lost tax benefits looms larger, and the amount saved because of the deferral or elimination of the need to borrow $50 million diminishes substantially.

[18]Again, this is an order-of-magnitude figure that is close enough for our purposes. PTUA uses the 1.95 multiplier throughout its briefs to compute the tax-on-tax effect of a revenue deficiency, and APS does not quarrel with it. The precise calculation is made somewhat difficult

Secondly, we must recognize that under the normalization rules that would have applied to the ACRS tax depreciation attributable to Cholla No. 4 the ratepayers would have benefited from reductions in the APS rate base if the utility had retained the right to use that accelerated tax depreciation. The Commission's regulations, 18 CFR 35.25(b)(2), provide that the rate base of a public utility using tax normalization (as a utility must do to compute its tax depreciation under the ACRS) must be reduced by the balances in its accumulated deferred income tax accounts. In general, those balances consist of the difference between the Federal income tax liability that the utility would have incurred if it had depreciated its assets for tax purposes on the same straight-line basis it employs for calculating book (*i.e.* financial and regulatory accounting) depreciation and the Federal income tax liability that is actually incurred. During the early years of a plant's service, the use of accelerated tax depreciation sharply decreases the firm's income tax liability and causes substantial sums to accumulate in the deferred tax accounts. The reduction of rate base by the accumulated deferred tax balances provides a substantial benefit to ratepayers who are thereby relieved of the obligation to pay return and carrying charges to the utility on a sum equivalent to the amount of deferred taxes deducted from the rate base. It is true that, as years go by, the accelerated tax write-offs will be exhausted, while straight-line book depreciation will go on, and the balances in the accumulated deferred tax accounts will be depleted until, at the end of the asset's economic life, they will equal zero. But the impact of the early years' rate base reductions is magnified by virtue of the discount that must be applied to amounts received and expended in later years in order to arrive at their present value. Consequently, it seems reasonable to say, as PTUA does, that the sale of ACRS tax deductions deprived the APS ratepayers of the benefits that would have flowed from the reduction of the utility's

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by the fact that the additional state and local income taxes are themselves deductible in determining the Federal income tax.

rate base, had the deductions been retained, by virtue of normalization (under the FERC regulations) of the difference between those write-offs and the use of straight line depreciation to compute the utility's income tax liability.

In Appendix A to this initial decision, I have calculated the amount that the ratepayers lost by virtue of the fact that the safe harbor transaction eliminated the reduction in rate base, and consequent reduction in return and carrying charges, that would otherwise have flowed from APS' use of the Accelerated Cost Recovery System to depreciate Cholla No. 4 for tax purposes and APS' use of the $25 million in investment tax credits attributable to investment in that plant. In making the calculation, it seemed appropriate to use the 12.76% overall rate of return authorized in the Phase I Decision. These calculations show that, owing to the safe harbor transaction, the ratepayers will pay $126,396,000 in additional return to APS during the economic life of Cholla No. 4. The carrying charges on that sum will add another $120,576,000 to the ratepayers' bill, because it will require $246,472,000 in gross revenues for APS to secure the additional $126,396,000 in return after taxes. Hence, the cost to ratepayers will be a stream of payments that add up to $246,472,000 over 30 years. That stream of payments has a present value (at an 18% discount rate) of $37,748,000.

I conclude, therefore, that the net present value of the costs that the ratepayers will incur by reason of the safe harbor transaction amounts to approximately $123.5 million.

It appears from the foregoing that the ultimate costs that the ratepayers will have to bear by reason of the safe harbor transaction outweigh, by a considerable margin, the financial benefit to them by virtue of the utility's receipt of the cash and tax-benefit proceeds of that transaction. The collateral advantage flowing from the deal, which APS cites, do not come close to redressing the balance. The record shows that, over the long haul, the ratepayers would have incurred less expense if APS had

borrowed the $50.625 million it secured from General Electric, even at the outlandish interest rate of 18%.[19]

This does not mean that APS acted in an imprudent manner when it consummated the safe harbor transaction. The evidence conclusively shows that the negotiations between APS and General Electric took place at arm's length. The weight of the evidence also shows that APS secured about the best price it could have expected for its tax benefits, given the then-current market for tax depreciation and investment tax credits, as well as the rather brief period of time the law provided for a safe harbor sale of ACRS deductions and investment tax credits attributable to investment in Cholla No. 4.[20]

The contention by PTUA to the contrary is supported only by some testimony of its witness Sherali to the effect that some hypothetical corporation might have been willing to pay up to $77,764,000 for the Cholla No. 4 tax benefits. *See* Exhibit No. 110, p. 9. Sherali's view on this point must be rejected as arrant speculation, however, in light of the contrary testimony of an APS witness who had actual experience about conditions in the tax-benefit marketplace. See, *e.g.*, Exhibit No. 115, p. 5. Tr. 2991, 3120-21, 3125-26. Further, the $50,625,000 of proceeds provided

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[19]It is axiomatic that if financing alternatives are analyzed on a present-value basis, the effect of a conventional borrowing transaction is virtually a "wash" because, assuming the interest rate on the loan is a valid surrogate for the current cost of money, the principal sum borrowed has a present value that is equivalent to the present value of the payments to amortize the principal and interest over the life of the loan. There is a small discontinuity in the validity of this analysis owing to brokers' commissions and other costs of borrowing that are deducted from the principal sum the borrower receives. But it is not significant enough to affect the result: one cannot logically defend APS' safe harbor deal with General Electric on the ground that it obviated the necessity for the utility to borrow $50.625 million at the then-current interest rates.

[20]Under section 168(f)(8)(D) of the Internal Revenue Code as added by ERTA, property such as Cholla No. 4 that was placed in service in 1981 before enactment of ERTA could qualify for safe harbor treatment only if the lease were entered into before November 13, 1981.

a small profit to APS on the value to the utility and its stockholders of the tax benefits it surrendered. As we have seen, from the utility's standpoint those tax benefits were worth a little more than $47 million. The value of those benefits to the ratepayers, however, was substantially in excess of the amount General Electric paid for them. Does this make the transaction an imprudent one? The answer must be no, unless there is a showing that, at the time it negotiated the deal, APS was under a legal obligation to protect the interests of its ratepayers at the expense of its corporate interests and those of its stockholders. No one in this proceeding has pointed to any source of such an obligation. No statute has been cited. No administrative order or regulation has been referred to. No judicial or administrative precedent, holding that a utility must protect the interests of its ratepayers while making a sale of its tax deductions and credits, has been brought to my attention. I have found none in my own research.

A regulated public utility does not act imprudently merely because it fails to act in the best interests of its ratepayers in circumstances where those interests conflict with the corporate interests of the utility and its stockholders. The task of protecting the interests of the ratepayers in those circumstances is a burden that rests upon the regulatory agencies that are authorized by law to regulate the rates and practices of the utility. *See Midwestern Gas Transmission Co.* v. *FPC*, 388 F.2d 444 (7th Cir.), *cert. denied*, 392 U.S. 928 (1968). There is, in short, a category of utility management actions which fall outside the sphere of imprudent activity, with its connotations of extravagance and waste of corporate resources (*see, e.g.*, *Acker* v. *United States*, 298 U.S. 426, 431 (1936); *Tennessee Gas Pipeline Co.*, 21 FERC ¶ 61,004 (1982)) but that are nevertheless subject to the agency's power to redress the balance of economic burdens and benefits when necessary to protect the ratepayers. That is the fundamental mission of this Commission (*see Atlantic Refining Co.* v. *Public Service Commission*, 360 U.S. 378 (1959)), which has itself recently reminded us that, at root, it is primarily a con-

sumer-protection agency. *Williams Pipe Line Co.* (Op. No. 154), 21 FERC ¶ 61,260 (1982).

PTUA's recommended remedy—requiring immediate flow-through to APS ratepayers of the full amount of the proceeds of the safe harbor deal or, indeed, an even larger sum representing the present value of the amount the ratepayers will lose over time—seems unduly punitive in character and, hence, is not appropriate where, as here, the utility has not been shown to have acted imprudently. Nevertheless, the relevant APS management decisions though not imprudent, plainly demand administrative redress to relieve the ratepayers of an undue burden that would otherwise rest on their shoulders. Accordingly, I conclude that while it would not be appropriate in this proceeding to punish APS for having consummated the safe harbor deal with General Electric, neither would it be appropriate for the Commission to look the other way and ignore the impact of the transaction on the ratepayers—as APS has suggested it should.

There are two strings to the company's bow. The first is the argument that adherence to the test-year concept requires the proceeds of the transaction to be excluded from consideration in this particular docket. APS points out that the sale of tax benefits took place "nearly one year after the company's filing and ten and one-half months into Period II." Initial Brief, p. 10. That being so, APS says, it was clearly proper for its test-year cost-of-service estimates to make no provision for the impact of the safe harbor transaction, since no one could predict that that transaction would take place (nor could anyone predict that the Internal Revenue Code would be amended to sanction the transaction) at the time the estimates were made. Consequently, the rule that test-year estimates will be accepted for ratemaking purposes, even though they vary from actual results, if they were reasonable when made (*see Indiana Municipal Electric Ass'n* v. *FERC*, 629 F.2d 480, 485 (7th Cir. 1980)) is invoked in support of APS' position.

There is, however, a well-established exception to that rule. Changes in circumstances that are deemed particu-

larly important or significant may be taken into account even though they were not, and could not have been, considered when the test-year estimates were prepared. For the most part, cases that have invoked this exception have involved changes to the regulated utility's capital structure between the time the estimates were prepared and the time the Commission's decision was rendered. *See, e.g., Illinois Power Co.* (Op. No. 816), 59 F.P.C. 1293, 1298 (1977); *Union Electric Co.* (Op. No. 609), 47 F.P.C. 144 (1972). But the exception is not limited to capital-structure adjustments. *See Arkansas-Louisiana Gas Co.* (Op. No. 160), 22 FERC ¶ 61,125 (1983). In *Otter Tail Power Co.* (Op. No. 93), 12 FERC ¶ 61,169 at p. 61,430 (1980), the Commission approved the use of actual test-year figures in lieu of the utility's estimates because "subsequent to the filing of those estimates, a change occurred in the tax laws that makes reliance on the estimates questionable." Here, too, significant tax law changes, and the utility's response to them, present the Commission with a situation warranting application of the exception to the general rule against taking account of actual data in lieu of the company's estimates in arriving at the cost of service for ratemaking purposes. In light of the significance that proper treatment of the safe harbor transaction will assume from the standpoint of the ratepayers during the life of that transaction, it seems appropriate for the Commission to come to grips with it as soon as possible. Because the issues have been thoroughly ventilated in a full evidentiary hearing in this proceeding, no useful purpose would be served by pretermitting the Commission's determination until a later day. Accordingly, I reject APS' contention that the questions arising out of its safe harbor deal should not be disposed of on the merits in this docket but should be put off until some future rate case is heard and decided.

The second APS contention is one we have previously noted. APS says that if the Commission considers on the merits the question of the proper ratemaking treatment of the safe harbor transaction, it should adopt the same

approach as the Arizona Corporation Commission took, permitting the utility to amortize the $50,625,000 lump sum payment from General Electric as a deduction from its income tax expense in equal installments over the economic life of Cholla No. 4, without requiring the unamortized balance to be deducted from rate base.[21] The difficulty with this proposal is that it is fundamentally unfair.

By any reasonable standard, the result APS is here advocating simply does not give adequate protection to the legitimate interests of the ratepayers. It would be grossly inequitable for the Commission to sanction the proposed trade-off of additional costs having a net present value of some $123.5 million in exchange for the reduction of the cost of service by amortization of $50,625,000 in equal installments over 30 years, a benefit that has a present value of approximately $10 million.[22] This, in substance, is what the utility says the Commission should do.

About the only thing that can be said in favor of the utility's proposal is that the Arizona Corporation Commission adopted it for retail ratemaking purposes. Other things being equal, there are unquestionable advantages in authorizing a public utility to follow the same accounting conventions and rate-development practices for its wholesale service as it does for its retail service. But other things are decidedly not equal in the circumstances of this case. Without casting aspersions at the perspicacity or good faith of the Arizona regulatory authorities, the facts as disclosed on the record of this proceeding speak forcefully in favor of rejecting the company's recommendation for the treatment of the safe harbor transaction proceeds

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[21]APS is also amenable to flowing through to its income tax expense the net annual deduction it is entitled to take on the matching "rent" and "purchase price installment" payments by it and General Electric. No participant seriously disputes the validity of this treatment of the tax consequences of these "wash" payments.

[22]The present value of $1,687,500 ($50,625,000 divided by 30) per year for 30 years at a discount rate of 18% is $9,307,610. To this figure must be added the $673,000 present value of the tax saving produced by the matching rent-v-purchase-price payments.

on the elemental ground that it does not represent a fair or just method of balancing the respective interests of APS and its ratepayers.

The variety and complexity of the apportionment theories that have been advanced upon this record are themselves eloquent testimony to why they represent an unacceptable resolution of the question before the Commission. At the threshold, one is tempted to ask why the Commission should place so much credence in a recommendation of its Chief Accountant's Office that did not prove to be persuasive to the agency's own Office of Electric Power Regulation, and *vice versa*. Quite apart from the Staff's inability to agree on a single methodology, however, there is the ineluctable arbitrariness of any method of attempting to allocate the proceeds of the transaction between a payment for ACRS deductions and a separate payment for investment tax credits. This is particularly true when there is no evidence that either, or both, of the parties to the transaction analyzed it in that fashion before the agreement was executed.

It seems purely speculative to say, as Staff witness McDanal did, that the price paid and received reflects the proportionate benefit that APS would have realized from the Cholla No. 4 ACRS deductions and investment tax credits, if APS had not gone ahead with the safe harbor sale of those entitlements. In this respect, Staff witness Bublitz was quite correct in his critique of McDanal's work. But Bublitz himself fell prey to baseless speculation when he was compelled by his theoretical model to make a number of arbitrary assumptions about the benefits that denizens of General Electric's executive suite thought that corporation could reap from the ACRS deductions and the investment tax credits. There was, for example, no evidentiary support proferred for the notion—basic to Bublitz's methodology—that General Electric's internal rate of return was 20%. Nor have we been given any satisfactory explanation of why the *average* of the respective valuations assigned to the buyer and the seller is the proper measure to use when allocating the proceeds. Adoption of Bublitz's

hypothesis, therefore, seems calculated to open a Pandora's Box of speculation whenever the Commission attempts to deal with the question of the proper treatment of a safe harbor transaction.

According to the Staff, the requirement to apportion the proceeds stems from the normalization mandate that Congress imposed on public utilities securing the new ACRS and investment tax credit benefits under the Economic Recovery Tax Act. ERTA, it is true, required utilities to normalize ACRS deductions and, in certain circumstances, investment tax credits. But there is nothing in the statute that requires normalization of the proceeds of the sale of those tax benefits. Nor is there any general doctrine of tax law that mandates giving the proceeds derived from selling an asset the same tax treatment that would have been accorded to the asset if the taxpayer had retained it. If, for instance, one exchanges a depreciable asset for a non-depreciable one (real estate, as an example), the fact of the exchange does not make the latter asset depreciable for tax purposes. Consequently, there is no basis in law for the contention that apportionment of the proceeds of a safe harbor transaction is necessary in order to provide the groundwork for normalization of the proceeds.

The apportionment technique espoused by intervenors' witness Darnall also suffers from the vice of arbitrariness. Certainly, one need not speculate to derive the figures that Darnall used to make his apportionment. He simply chose to regard the $25 million of investment tax credits sold by APS as having been paid for, dollar-for-dollar, by the proceeds and attributed the balance of the $50,625,000 paid by General Electric to ACRS deductions. What is missing from Darnall's theory is an explanation of why a corporation with over $50 million in cold cash on hand would pay $25 million in present-day funds for investment tax credits that might, at best, produce an aggregate tax saving of only $25 million during some future period. Absent such an explanation (and none occurs readily to me or is revealed by examination of the record), Darnall's

apportionment thesis must be found to lack an adequate theoretical or evidentiary basis.

For the foregoing reasons, it is necessary to reject all of the apportionment theories that have been offered as useful tools for the Commission to employ in determining what treatment should be given to safe harbor transactions involving regulated public utilities. Those theories are fundamentally grounded upon a legal fiction: that the proceeds of the transaction consist of the sum of an amount that was paid for ACRS deductions and a separate amount that was paid for investment tax credits. Both the record in this case and the Commission's experience with related problems—such as tax normalization—teach that it is bad law and bad policy to attempt the resolution of difficult issues by the creation of fictions. Not the least of the difficulties that one encounters is the inevitability of having to create additional fictions to deal with the disparities caused by the initial fictions.[23] We do well to remind ourselves, however, that there is a reality that must be respected and to which the solutions to legal and policy questions must be fitted. The idea that the $50,625,000 in up-front cash that APS received for the Cholla No. 4 tax benefits constituted anything except a negotiated price for a "package" of non-severable tax benefits is illusory and unworkable. We should not deceive ourselves by assuming that the proceeds can be separated into components in some viable fashion.

Nor, for reasons set out at length earlier, should we proceed on the equally fictitious basis that APS received something more than the sum it actually realized and thereby require the utility to reduce its cost of service by some larger amount in a foolhardy attempt to "make

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[23]Use of the normalization convention, for instance, creates large balances in deferred tax accounts. This, in turn, leads regulatory agencies to mandate the deduction of those balances from the utility's net invested capital dedicated to providing service to the ratepayers. Thus, the ordination of a fictitious tax expense for the utility results in an equally fictitious rate base for the utility.

whole" the ratepayers. The fact is that we cannot make them whole, and there is no just reason to punish the utility. Safe harbor transactions were perfectly legal at the time APS entered into this particular agreement, and, as noted above, APS appears to have secured the best price obtainable in the prevailing market for its Cholla No. 4 tax benefits. Those tax benefits having been sold, we cannot pretend that they are still available, much as it may tempt us to so out of a sense of frustration at the uneveness of the bargain that was struck between the respective interests of the ratepayers and APS.[24]

The best that we can do to achieve a just and equitable result is to adopt the alternate resolution propounded by intervenor witness Darnall. He suggested that if apportionment of the proceeds were deemed unsuitable, the $50,625,000 cash payment received by APS should be amortized as a reduction of the tax expense of the utility over the service life of the plant, with the unamortized balance being deducted from the utility's rate base. While this solution is imperfect, it appears to come closer to striking a fair balance between the respective interests at stake than any other that has been suggested upon this record.

The company's objections to this treatment of the proceeds are, in my judgment, meritless. APS argues that deduction of the unamortized balance of the proceeds from the rate base is unfair because, contrary to the situation when deferred tax balances are deducted from rate base, the amount in question does not represent customer-contributed capital. The sum in question constitutes the proceeds from the sale of tax benefits that, if retained, would have meant a saving on the part of those ratepayers of many times that sum over the years. Whether we formally denominate those rights as assets or not, the total effect is close enough to a sale of customer-financed property to

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[24]The silver lining in this particular cloud is that the Congress, which authorized these safe harbor transactions, has had the good sense to reverse its direction after a brief experience with them. See n.3, *supra*.

make the analogy to the normalization treatment an apt one.

Finally, APS urges that deduction of the unamortized balance of the proceeds from rate base would eliminate any incentive on the part of public utilities to enter into safe harbor transactions, contrary to the intention of the Congress that enacted ERTA. Whether the Congress did intend to enact an affirmative spur to safe harbor transactions, rather than merely to allow them to take place is rather questionable. There are those who see in the brief experiment with favorable tax treatment for these transactions an effort to achieve beneficial social goals above and beyond mere tolerance of the normal disinclination of businessmen to pay taxes. *See* A.C. Warren, Jr. and A.J. Auerbach, *Transferability of Tax Incentives and the Fiction of Safe Harbor Leasing*, 95 Harv. L. Rev. 1752 (1982). Examination in detail of the hard facts of one such transaction, as disclosed on the record of this case, casts considerable doubt on the validity of that hypothesis. It is significant, in this respect, that the Congress did not in ERTA mandate or prohibit any specific treatment of safe harbor proceeds in the hands of regulated public utilities. Since that same Congress included in the Act very specific directives with respect to the treatment of ACRS deductions and investment tax credits of regulated public utilities, it cannot be said that there was a lack of awareness on Congress' part of the risk that regulatory agencies might require substantial proportions of the benefits of the transactions to be flowed through to the ratepayers. This is, in short, a situation where congressional silence speaks volumes. The absence of a prohibition in ERTA on the reduction of rate base by the unamortized proceeds of safe harbor leases signifies that no such prohibition was intended. It also belies APS' argument that that treatment of the proceeds would seriously transgress the intention of the Congress that enacted ERTA.

There is one other resolution of the controversy that recommends itself, even though no participant has advocated it. That resolution is simply to disregard the tax

benefit transfer transaction and to prescribe rates for APS as if that transaction had never occurred. APS would be required to amortize the investment tax credits attributable to Cholla No. 4 to its cost of service ratably over the plant's economic life, to deduct straight-line book depreciation on Cholla No. 4 in computing the utility's income tax allowance, and to normalize the difference between those depreciation figures and ACRS depreciation on the plant in accordance with relevant FERC regulations. This disposition has the virtue of requiring APS to bear the risk of potential loss, and allowing it to secure any gain, that results from the safe harbor transaction, without imposing on the ratepayers a burden they would not have borne in the absence of that transaction.

It is a close question whether to adopt this latter resolution or the Darnall alternate, under which the proceeds of the transaction would be amortized to the cost of service over the economic life of the plant, with the unamortized balance being deducted from the rate base. I opt in favor of the Darnall alternate primarily because of my conviction that the Commission should adhere to the realities of these transactions and should not adopt fictitious premises—such as the notion that the Cholla No. 4 tax benefits remain in APS' hands—as the vehicle for disposing of the controversy over the rate consequences of the transactions. My reasons for that conviction are explained above.

This phase of the case was initiated for the purpose of determining how to treat the proceeds of the APS-General Electric transaction in regulating the jurisdictional rates of APS. That is exactly what it should do.[25]

In consideration of the foregoing findings of fact and conclusions of law, and in consideration of the findings of fact and conclusions of law set forth in the Phase I Decision, IT IS FURTHER ORDERED, subject to review by the Federal Energy Regulatory Commission on appeal or

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[25]In addition, APS is required to flow through the tax saving resulting from the equal "rent" and "purchase price" payments under its contract with General Electric. See note 21, *supra*.

on the Commission's own motion, as provided in the Rules of Practice and Procedure, that --

A. Not later than 60 days after this initial decision becomes final and non-appealable, APS shall recompute its jurisdictional rates and charges so that those rates and charges conform to the findings and conclusions of this decision and shall file the recomputed rates and charges with the Federal Energy Regulatory Commission.

B. Within 30 days after the Commission approves its recomputed rates and charges filed in accordance with paragraph A, *supra*, APS shall refund to its jurisdictional customers who had previously been subject to the rates and charges filed in this docket all amounts collected and received from them in excess of the approved rates, together with interest thereon in accordance with 18 CFR 35.19(a). Within 15 days thereafter, APS shall file with the Commission a report showing the computation of the refunds and the interest paid. A copy of the refund report shall also be provided to all state regulatory agencies having jurisdiction of customers affected by this order.

Isaac D. Benkin
Presiding Administrative Law Judge

APPENDIX
(000)

Year	(1) Accumulated Balance Deferred Taxes *	(2) Average or Mid-Year Accumulated Balance *	(3) Return on Average Balance (12.76% Col. 2)	(4) Effect of "Tax-on-Tax" (Col. 3 x 1.95)	(5) Mid—Year Present Value of Col. 3 at 18% Discount
1	$ 4,026	$ 2,013	$ 257	$ 501	$ 461
2	12,077	8,051	1,028	2,005	1,564
3	18,906	15,491	1,977	3,855	2,549
4	24,514	21,710	2,771	5,403	3,027
5	28,900	26,707	3,408	6,646	3,156
6	33,286	31,093	3,967	7,736	3,113
7	36,450	34,868	4,449	8,676	2,959
8	39,614	38,032	4,853	9,463	2,735
9	42,778	41,196	5,257	10,251	2,511
10	45,942	44,360	5,660	11,037	2,291
11	49,106	47,524	6,064	11,825	2,080
12	52,270	50,688	6,468	12,613	1,880
13	55,434	53,852	6,871	13,398	1,692
14	58,598	57,016	7,276	14,188	1,519
15	61,762	60,180	7,679	14,974	1.358
16	57,596	59,679	7,615	14,849	1,142
17	53,430	55,513	7,084	13,814	900
18	49,264	51,347	6,552	12,776	705
19	45,098	47,181	6,020	11,739	549
20	40,932	43,015	5,488	10,702	424
21	36,766	38,849	4,958	9,668	325
22	32,600	34,683	4,426	8,631	246
23	28,434	30,517	3,894	7,593	183
24	24,268	26,351	3,362	6,556	134
25	20,102	22,185	2,831	5,520	96
26	15,936	18,019	2,299	4,483	66
27	11,770	13,853	1,768	3,448	43
28	7,604	9,687	1,236	2,410	25
29	3,438	5,521	705	1,375	12
30	0	1,355	173	337	3
		TOTAL	$126,396	$246,472	$37,748

*Figures in these columns taken from table on p. 30 of PTUA Initial Brief

APPENDIX E
Statutes

Federal Power Act
Section 205, 16 U.S.C. § 824d.

§824d. Rates and charges; schedules; suspension of new rates

(a) All rates and charges made, demanded, or received by any public utility for or in connection with the transmission or sale of electric energy subject to the jurisdiction of the Commission, and all rules and regulations affecting or pertaining to such rates or charges shall be just and reasonable, and any such rate or charge that is not just and reasonable is hereby declared to be unlawful.

(b) No public utility shall, with respect to any transmission or sale subject to the jurisdiction of the Commission, (1) make or grant any undue preference or advantage to any person or subject any person to any undue prejudice or disadvantage, or (2) maintain any unreasonable difference in rates, charges, service, facilities, or in any other respect, either as between localities or as between classes of service.

(c) Under such rules and regulations as the Commission may prescribe, every public utility shall file with the Commission, within such time and in such form as the Commission may designate, and shall keep open in convenient form and place for public inspections schedules showing all rates and charges for any transmission or sale subject to the jurisdiction of the Commission, and the classifications, practices, and regulations affecting such rates and charges, together with all contracts which in any manner affect or relate to such rates, charges, classifications, and services.

(d) Unless the Commission otherwise orders, no change shall be made by any public utility in any such rate, charge, classification, or service, or in any rule, regulation, or contract relating thereto, except after thirty days' notice to the Commission and to the public. Such notice shall be given by filing with the Commission and keeping open for

public inspection new schedules stating plainly the change or changes to be made in the schedule or schedules then in force and the time when the change or changes will go into effect. The Commission, for good cause shown, may allow changes to take effect without requiring the thirty days' notice herein provided for by an order specifying the changes so to be made and the time when they shall take effect and the manner in which they shall be filed and published.

(e) Whenever any such new schedule is filed the Commission shall have authority, either upon complaint or upon its own initiative without complaint, at once, and, if it so orders, without answer or formal pleading by the public utility, but upon reasonable notice, to enter upon a hearing concerning the lawfulness of such rate, charge, classification, or service; and, pending such hearing and the decision thereon, the Commission, upon filing with such schedules and delivering to the public utility affected thereby a statement in writing of its reasons for such suspension, may suspend the operation of such schedule and defer the use of such rate, charge, classification, or service, but not for a longer period than five months beyond the time when it would otherwise go into effect; and after full hearings, either completed before or after the rate, charge, classification, or service goes into effect, the Commission may make such orders with reference thereto as would be proper in a proceeding initiated after it had become effective. If the proceeding has not been concluded and an order made at the expiration of such five months, the proposed change of rate, charge, classification, or service shall go into effect at the end of such period, but in case of a proposed increased rate or charge, the Commission may by order require the interested public utility or public utilities to keep accurate account in detail of all amounts received by reason of such increase, specifying by whom and in whose behalf such amounts are paid, and upon completion of the hearing and decision may by further order require such public utility or public utilities to refund, with interest, to the persons in whose behalf such

amounts were paid, such portion of such increased rates or charges as by its decision shall be found not justified. At any hearing involving a rate or charge sought to be increased, the burden of proof to show that the increased rate or charge is just and reasonable shall be upon the public utility, and the Commission shall give to the hearing and decision of such questions preference over other questions pending before it and decide the same as speedily as possible.

Federal Power Act
Section 206, 16 U.S.C. §§ 824e.

§824e. Power of Commission to fix rates and charges; determination cost of production or transmission

(a) Whenever the Commission, after a hearing had upon its own motion or upon complaint, shall find that any rate, charge, or classification, demanded, observed, charged, or collected by any public utility for any transmission or sale subject to the jurisdiction of the Commission, or that any rule, regulation, practice, or contract affecting such rate, charge, or classification is unjust, unreasonable, unduly discriminatory or preferential, the Commission shall determine the just and reasonable rate, charge, classification, rule, regulation, practice, or contract to be thereafter observed and in force, and shall fix the same by order.

Economic Recovery Tax Act (ERTA)
26 U.S.C. 46(f)(1)(2) and (3)

(f) Limitation in Case of Certain Regulated Companies.—

(1) General Rule.—Except as otherwise provided in this subsection, no credit shall be allowed by section 38 with respect to any property described in section 50 which is public utility property (as defined in paragraph (5)) of the taxpayer—

(A) Cost of service reduction.—If the taxpayer's cost of service for ratemaking purposes is reduced by reason of any portion of the credit allowable by section 38 (determined without regard to this subsection); or

(B) Rate base reduction.—If the base to which the taxpayer's rate of return for ratemaking purposes is applied is reduced by reason of any portion of the credit allowable by section 38 (determined without regard to this subsection).

Subparagraph (B) shall not apply if the reduction in the rate base is restored not less rapidly than ratably. If the taxpayer makes an election under this sentence within 90 days after the date of the enactment of this paragraph in the manner prescribed by the Secretary, the immediately preceding sentence shall not apply to property described in paragraph (5)(B) if any agency or instrumentality of the United States having jurisdiction for ratemaking purposes with respect to such taxpayer's trade or business referred to in paragraph (5)(B) determines that the natural domestic supply of the product furnished by the taxpayer in the course of such trade or business is insufficient to meet the present and future requirements of the domestic economy.

(2) Special rule for ratable flow-through—If the taxpayer makes an election under this paragraph within 90 days after the date of the enactment of this paragraph in the manner prescribed by the Secretary, paragraph (1) shall not apply, but no credit shall be allowed by section 38 with respect to any property described in section 50 which is public utility property (as defined in paragraph (5)) of the taxpayer—

(A) Cost of service reduction—If the taxpayer's cost of service for ratemaking purposes or in its regulated books of account is reduced by more than a ratable portion of the credit allowable by section 38 (determined without regard to this subsection), or

(B) Rate base reduction—If the base to which the taxpayer's rate of return for ratemaking purposes is applied is reduced by reason of any portion of the credit allowable by section 38 (determined without regard to this subsection).

(3) Special rule for immediate flow-through in certain cases.—In the case of property to which section

167(1)(2)(C) applies, if the taxpayer makes an election under this paragraph within 90 days after the date of the enactment of this paragraph in the manner prescribed by the Secretary, paragraphs (1) and (2) shall not apply to such property.

26 U.S.C. 168(e)(1)(2) and (3)
SEC. 201. ACCELERATED COST RECOVERY SYSTEM.

(a) IN GENERAL.—Part VI of subchapter B of chapter 1 (relating to itemized deductions for individuals and corporations) is amended by inserting after section 167 the following new section:

* * * * * * *

"(e) PROPERTY EXCLUDED FROM APPLICATION OF SECTION.—For purposes of this section—

"(1) PROPERTY PLACED IN SERVICE BEFORE JANUARY 1, 1981.—The term 'recovery property' does not include property placed in service by the taxpayer before January 1, 1981.

"(2) CERTAIN METHODS OF DEPRECIATION—The term 'recovery property' does not include property if—

"(A) the taxpayer elects to exclude such property from the application of this section, and

"(B) for the first taxable year for which a deduction would (but for this election) be allowable under this section with respect to such property in the hands of the taxpayer, the property is properly depreciated under the unit-of-production method or any method of depreciation not expressed in a term of years (other than the retirement-replacement-betterment method).

"(3) SPECIAL RULE FOR CERTAIN PUBLIC UTILITY PROPERTY.—

"(A) IN GENERAL—The term 'recovery property' does not include public utility property (within the meaning of section 167(1)(3)(A)) if the taxpayer does not use a normalization method of accounting.

"(B) USE OF NORMALIZATION METHOD DEFINED.—For purposes of subparagraph (A), in order to use

a normalization method of accounting with respect to any public utility property—

"(i) the taxpayer must, in computing its tax expense for purposes of establishing its cost of service for ratemaking purposes and reflecting operating results in its regulated books of account, use a method of depreciation with respect to such property that is the same as, and a depreciation period for such property that is no shorter than, the method and period used to compute its depreciation expense for such purposes; and

"(ii) if the amount allowable as a deduction under this section with respect to such property differs from the amount that would be allowable as a deduction under section 167 (determined without regard to section 167(l)) using the method (including the period, first and last year convention, and salvage value) used to compute regulated tax expense under subparagraph (B)(i), the taxpayer must make adjustments to a reserve to reflect the deferral of taxes resulting from such difference.

"(C) PUBLIC UTILITY PROPERTY WHICH IS NOT RECOVERY PROPERTY.—In the case of public utility property which, by reason of this paragraph, is not treated as recovery property, the allowance for depreciation under section 167(a) shall be an amount computed using the method and period referred to in subparagraph (B)(i).

ERTA Section 201(f)(8)—95 Stat. 214-216

"(8) SPECIAL RULE FOR LEASES.—

"(A) IN GENERAL.—In the case of an agreement with respect to qualified leased property, if all of the parties to the agreement characterize such agreement as a lease and elect to have the provisions of this paragraph apply with respect to such agreement, and if the requirements of subparagraph (B) are met, then, for purposes of this subtitle—

"(i) such agreement shall be treated as a lease entered into by the parties (and any party which

is a corporation described in subparagraph (B)(i)(I) shall be deemed to have entered into the lease in the course of carrying on a trade or business), and

"(ii) the lessor shall be treated as the owner of the property and the lessee shall be treated as the lessee of the property.

"(B) CERTAIN REQUIREMENTS MUST BE MET.—The requirements of this subparagraph are met if—

" (i) The lessor is—

" (I) a corporation (other than an electing small business corporation (within the meaning of section 1371(b)) or a personal holding company (within the meaning of section 542(a))),

" (II) a partnership all of the partners of which are corporations described in subclause (I), or

"(III) a grantor trust with respect to which the grantor and all beneficiaries of the trust are described in subclause (I) or (II),

" (ii) the minimum investment of the lessor—

" (I) at the time the property is first placed in service under the lease, and

"(II) at all times during the term of the lease, is not less than 10 percent of the adjusted basis of such property, and

"(iii) the term of the lease (including any extensions) does not exceed the greater of—

" (I) 90 percent of the useful life of such property for purposes of section 167, or

"(II) 150 percent of the present class life of such property.

"(C) NO OTHER FACTORS TAKEN INTO ACCOUNT—If the requirements of subparagraphs (A) and (B) are met with respect to any transaction described in subparagraph (A), no other factors shall be taken into account in making a determination as to whether subparagraph (A)(i) or (ii) applies with respect to such transaction.

"(D) QUALIFIED LEASED PROPERTY DEFINED.—For the purposes of subparagraph (A), the term 'qualified leased property' means recovery property (other than a qualified rehabilitated building within the meaning of section 48(g)(1)) which is—

" (i) new section 38 property (as defined in section 48(b)) of the lessor which is leased within 3 months after such property was placed in service and which, if acquired by the lessee, would have been new section 38 property of the lessee,

" (ii) property—

" (I) which was new section 38 property of the lessee,

" (II) which was leased within 3 months after such property was placed in service by the lessee, and

"(III) with respect to which the adjusted basis of the lessor does not exceed the adjusted basis of the lessee at the time of the lease, or

"(iii) property which is a qualified mass commuting vehicle (as defined in section 103(b)(9)) and which is financed in whole or in part by obligations the interest on which is excludable from income under section 103(a).

For purposes of this title (other than this subparagraph), any property described in clause (i) or (ii) to which subparagraph (A) applies shall be deemed originally placed in service not earlier than the date such property is used under the lease. In the case of property placed in service after December 31, 1980, and before the date of the enactment of this subparagraph, this subparagraph shall be applied by submitting 'the date of the enactment of this subparagraph' for 'such property was placed in service'.

"(E) MINIMUM INVESTMENT—

" (i) IN GENERAL.—For purposes of subparagraph (A), the term 'minimum investment' means the amount the lessor has at risk with respect to the property (other than financing from the lessee or a related party of the lessee).

"(ii) SPECIAL RULE FOR PURCHASE REQUIREMENT.—for purposes of clause (i), an agreement between the lessor and lessee requiring either or both parties to purchase or sell the qualified leased property at some price (whether or not fixed in the agreement) at the end of the lease term shall not affect the amount the lessor is treated as having at risk with respect to the property.

"(F) CHARACTERIZATION BY PARTIES.—For purposes of this paragraph, any determination as to whether a person is a lessor or lessee or property is leased shall be made on the basis of the characterization of such person or property under the agreement described in subparagraph (A).

"(G) REGULATIONS.—The Secretary shall prescribe such regulations as may be necessary to carry out the purposes of this paragraph, including (but not limited to) regulations consistent with such purposes which limit the aggregate amount of (and timing of) deductions and credits in respect of qualified leased property to the aggregate amount (and the timing) allowable without regard to this paragraph.

"(H) CROSS REFERENCE.—

"For special recapture in cases where lessee acquires qualified leased property, see section 1245.

ERTA Section 209(d)—95 Stat. 172, 226-227

(d) SPECIAL RULE FOR PUBLIC UTILITIES.—

(1) TRANSITIONAL RULE FOR NORMALIZATION REQUIREMENTS.—If, by the terms of the applicable rate order last entered before the date of the enactment of this Act by a regulatory commission having appropriate jurisdiction, a regulated public utility would (but for this provision) fail to meet the requirements of section 168(e)(3) of the Internal Revenue Code of 1954 with respect to property because, for an accounting period ending after December 31, 1980, such

public utility used a method of accounting other than a normalization method of accounting, such regulated public utility shall not fail to meet such requirements if, by the terms of its first rate order determining cost of service with respect to such property which becomes effective after the date of the enactment of this Act and on or before January 1, 1983, such regulated public utility uses a normalization method of accounting. This provisions shall not apply to any rate order which, under the rules in effect before the date of the enactment of this Act, required a regulated public utility to use a method of accounting with respect to the deduction allowable by section 167 which, under section 167(l), it was not permitted to use.

(2) TRANSITIONAL RULE FOR REQUIREMENTS OF SECTION 46(F).—If, by the terms of the applicable rate order last entered before the date of the enactment of this Act by a regulatory commission having appropriate jurisdiction, a regulated public utility would (but for this provision) fail to meet the requirements of paragraph (1) or (2) of section 46(f) of the Internal Revenue Code of 1954 with respect to property for an accounting period ending after December 31, 1980, such regulated public utility shall not fail to meet such requirements if, by the terms of its first rate order determining cost of service with respect to such property which becomes effective after the date of the enactment of this Act and on or before January 1, 1983, such regulated public utility meets such requirements. This provision shall not apply to any rate order which, under the rules in effect before the date of the enactment of this Act, was inconsistent with the requirements of paragraph (1) or (2) of section 46(f) of such Code (whichever would have been applicable).

(3) CLARIFICATION.—Subparagraph (C) of section 167(l)(3) is amended by inserting "and which is placed in service before January 1, 1981" immediately before the period at the end thereof.

(4) AUTHORITY TO PRESCRIBE INTERIM REGULATIONS WITH RESPECT TO NORMALIZATION.—Until Congress

acts further, the Secretary of the Treasury or his delegate may prescribe such interim regulations as may be necessary or appropriate to determine whether the requirements of section 168(e)(3)(B) of the Internal Revenue Code of 1954 have been met with respect to property placed in service after December 31, 1980.